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DEVELOPMENTS IN MEXICO AND UNITED STATES-MEXICAN RELATIONS

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HEARING

BEFORE THE

SUBCOMMITTEE ON WESTERN HEMISPHERE AFFAIRS

OF THE

COMMITTEE ON FOREIGN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

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DEVELOPMENTS IN MEXICO AND UNITED STATES-MEXICAN RELATIONS

WEDNESDAY, OCTOBER 16, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON FOREIGN AFFAIRS,
SUBCOMMITTEE ON WESTERN HEMISPHERE AFFAIRS,
Washington, DC.

The subcommittee met, at 2:07 p.m., in room 2172, Rayburn House Office Building, Hon. Michael D. Barnes (chairman of the subcommittee) presiding.

Mr. BARNES. Ladies and gentlemen, the subcommittee will come to order.

The purpose of today's hearing is to analyze recent developments in Mexico, including the effects of the earthquake and the U.S. efforts to help in the reconstruction.

Mexico has been described as a showcase of debt management in the Third World, but now it is evident that its financial problems are reaching crisis proportions. The subcommittee is, therefore, interested in learning from the administration what strategies are being considered to help Mexico deal with its foreign debt.

My colleagues and I are also interested in discussing with our witnesses this afternoon political developments in Mexico, including press reports that described both widespread fraud during the last elections and the loss of popular support by the PRI, the party that has ruled Mexico for the last five decades.

Finally, we want to discuss the outstanding issues in our bilateral relations, including border issues related to the environment, economic cooperation between border states, trade and, not the least important, antidrug cooperation.

Before introducing our witnesses for this afternoon, I want to recognize my colleagues on the subcommittee. First of all, of course, the ranking minority member, the gentleman from California, for any statement he may wish to make at this time.

Mr. LAGOMARSINO. Thank you, Mr. Chairman.

I want to commend you for calling this hearing, for focusing on the importance of United States-Mexican relations. I have myself participated in the United States-Mexico Interparliamentary Conferences over the past 10 years, and one of the recurring themes at those conferences is the need for continuing attention by Members of Congress to the range of bilateral issues affecting relations with our neighbor to the south.

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REAGAN ADMINISTRATION ATTENTION TO MEXICO

As a way of indicating the importance this administration and I personally attach to close relations with the Government of Mexico, I would like to recount an anecdote from 4 years ago. After Ronald Reagan was elected President but before he was inaugurated, I wrote him a letter suggesting the first foreign leader he should meet with should be the President of Mexico. Whether he took my suggestion or was merely on the same wavelength, I will never know. I would not ask because I would probably be disappointed. But you will remember that Reagan met with the President of Mexico even before he was inaugurated. I tell that story as a prolog for one comment I wish to make about today's hearing.

Governor Babbitt of Arizona is appearing as a witness at today's hearing, and I welcome you here. I must admit I was quite disappointed in comments made by the Governor in an article in the May 28 issue of the Los Angeles Times. In that article he criticized the Reagan administration for not being sensitive to the needs and concerns of Mexico and said, "It is an important neighbor that needs sustained attention, including the personal attention of the President of the United States."

I would contend, Mr. Chairman, that no President in the history of the United States has devoted more personal attention to Mexico nor has done more to insure close personal contacts between the leaders of our two nations than Ronald Reagan, as I wrote in my response to the article, which the Los Angeles Times printed on June 22. As a matter of fact, the Commissioner of Immigration, Alan Nelson, wrote to me following the publication of my comments to emphasize his work and that of the administration of maintaining extensive contacts with Mexicans.

I would ask that Governor Babbitt's commentary, my response to it, and the letter from Commissioner Nelson be included in the record at this point.

Mr. BARNES. Without objection, so ordered.

[The information follows:]

[From the Los Angeles Times, May 28, 1985]

PUSHING A GOOD NEIGHBOR TOO FAR

UNITED STATES-MEXICAN PROBLEMS WORSEN UNDER OUR CAVALIER ATTITUDE

(By Hon. Bruce Babbitt)

The real issue in Central America is Mexico. It is the ultimate domino—a country of 75 million, 25 times larger than Nicaragua, 15 times larger than El Salvador—and it's right on our border.

Our relations with Mexico, never easy are once again deteriorating. Border problems are being neglected. Our differences over Nicaragua are creating new tensions. And many Mexicans are apprehensive that the United States is once again ready to intervene in their affairs.

Drug-trafficking is the most publicized of our border problems. In March the Reagan Administration embarrassed the Mexican government with a theatrical border closing, staged to protest the murder of an American drug-enforcement agent in Guadalajara. The border has long since been reopened, but resentment lingers on. (Mexicans contrast that incident with the President's conciliatory reaction to the Soviets' murder of an American officer in East Germany.) If the Administration is serious about drug enforcement, it must reduce the inflammatory rhetoric and increase the cooperative effort.

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Two disputes of a more regional nature are contributing to border friction. Raw sewage from Tijuana threatens San Diego beaches. And huge copper smelters on both sides of the border are playing havoc with the local environment and spreading acid rain as far as the Rocky Mountains.

In 1983 our two presidents met in Baja California to discuss environmental issues. But President Reagan chose instead to lecture his host about Central America; another opportunity was lost, and the issue now languishes in the hands of functionaries. Early this month 10 Southwestern senators and members of Congress from both parties urged Reagan to intervene personally with President Miguel de la Madrid to break the impasse over smelther controls. Nothing is likely to happen until our President heeds that appeal.

Trade is another nettlesome issue. In 1980 Mexico elected not to join the international General Agreement on Tariffs and Trade. Since then Mexico has been in limbo, struggling for access to U.S. markets under vague rules that often accord better treatment to the Soviet Bloc. De la Madrid has repeatedly warned that, without export earnings, Mexico cannot hope to earn the dollars needed to repay the $40 billion owed to American banks.

Last month the Administration finally granted Mexico parity with the GATT countries in the use of the "injury test," which prohibits the application of countervailing duties unless American industries can demonstrate actual damage from imports. But broader trade issues are still unresolved, and a draft bilateral treaty languishes for lack of high-level attention.

Immigration issues, too, remain unsettled after three years of acrimonious congressional debate. Mexican officials concede that immigration policy is an internal issue for Americans to decide, but they question the lack of consultation on a matter of such importance to both countries. Meanwhile, border incidents escalate.

Apart from these specific friction points, our good-neighbor relationship is being poisoned by a more subtle and pervasive long-term problem. Conservative activists in this country are starting to view Mexico as an uncooperative neighbor that should be pressured to support Reagan policies in Central America. Last year the National Security Council wrote a directive designed to apply such pressure. This is nothing less than a clandestine effort to undo 50 years of a foreign-policy modus vivendi between the United States and Mexico.

On inter-American matters Mexico has traditionally gone its own way—maintaining relations with Cuba, supporting the Sandinistas, opposing the Pinochet dictatorship and sponsoring the Contadora process in Central America. This independence has placated the left in internal politics, promoted Mexican prestige in the Third World and given Mexican presidents room to cooperate quietly with the United States on other East-West issues.

Attempts to make Mexico "cry uncle" by obediently echoing American initiatives is an ominous indicator that this Administration has no sense of either American or Mexican history, and little regard for the consequences to the United States of pushing a good neighbor too far.

An evangelistic strain is also creeping into our domestic political involvement with Mexico. The appearance of delegates from the conservative opposition party, PAN, at the Republican national convention in Dallas touched a raw nerve in Mexican politics.

Some Mexican journalists even allege that PAN is receiving financial support from American groups, although there is no hard evidence of such support.

The PAN (National Action Party), historically a token opposition, now poses a real threat to the Institutional Revolutionary Party (PRI). the challenge will climax in July with gubernatorial elections in seven states, including the key border states of Sonora and Nuevo Leon. The PRI has never let a governorship slip into PAN hands, and the odds are that it will not do so this time, even if the result is more violence and dissension than was seen in last fall's contested municipal elections.

However, the transition to a more open political system will inevitably continue, and will subject the Mexican system to its greatest stress since revolutionary times.

If the American right yields to the temptation to affiliate, however loosely, with the PAN, Mexicans will characterize the evolution of their political system as a fight between pro-American imperialists and anti-American revolutionaries. The results will be tragic for both countries.

There is still time to reverse the downward spiral of our relationship with Mexico. The first imperative is a change of attitude in Washington. Mexico is not just another Third World country. It is an important neighbor that needs sustained attention, including the personal attention of the President of the United States.

The broader imperative is to examine and modify the ingrained cultural attitudes that lead Americans to misunderstand Mexico as just an extension of our social, po-

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litical and economic values. Mexico is different; we are both united and divided by two languages, two cultures and 300 years of history.

[From the Los Angeles Times, June 22, 1985]

United States Policy Toward Mexico Not at Fault

(By Hon. Robert J. Lagomarsino)

A commentary in the May 28 Los Angeles Times by Bruce Babbitt, Democratic governor of Arizona, complains that the Reagan Administration is "pushing a good neighbor too far." He writes that the downward spiral of our relationship with Mexico requires a change of attitude in Washington, including the personal attention of the President of the United States.

I would contend that no president in the history of the United States has devoted more personal attention to Mexico nor has done more to ensure close personal contact between the leaders of our two nations than Ronald Reagan. As you will recall, even before his inauguration, President-elect Reagan met with the then-President of Mexico Lopez Portillo. He has followed that with regular meetings with President de la Madrid.

The problems encountered in the broad range of relations between the United States and Mexico are not the result of an insensitivity on the part of one government or another. They are the result precisely of the differences that mark our two cultures, two societies and two distinct histories of development.

During the recent 25th annual Mexico-U.S. Interparliamentary Conference, which I attended, one of the conclusions of the meeting was the recognition that despite the many problems that affect our bilateral relations, our ties are like a marriage, where we can have disagreements and differences of opinion, all the while knowing our basic relationship is sound. That in no way minimizes the problems we share, but there is certainly no lack of perseverance on the part of the Reagan Administration to seek to address those problems in a way that is both beneficial to U.S. interests and also sensitive to the needs and interests of Mexico.

Some of the areas that Governor Babbitt chooses to criticize strike me as either hypocritical or ill-informed. He points to the appearance of delegates from the conservative opposition party PAN at the Republican National Convention in Dallas as an inappropriate affiliation with the American right but ignores the appearance of delegates from the government party PRI at the Democratic National Convention.

The governor also criticizes the Administration for its handling of trade issues with Mexico. He acknowledges the agreement in April reached by Mexico and the United States for the application of an "injury test" for Mexican imports that compete with the products of American industries in exchange for Mexico's ending of export subsidies, but he ignores the statement issued at the same time which expresses the intent of both nations to negotiate a comprehensive, bilateral trade and investment agreement.

Immigration issues remain, yes, but the proposals coming from the Reagan Administration and the Congress are not suggesting two thousand miles of fence be erected as a way of solving that problem, as I recall was the case from the previous Administration.

During the Interparliamentary Conference, there was a full discussion of all the problems that affect the relations between the United States and Mexico. We touched on political, economic, social, environmental and cultural issues. There was a candid, frank exchange of views that clearly laid out the concerns of both nations. But, with those discussions on the parliamentary level, reflecting the same nature as talks held on a diplomatic or even presidential level, both sides agreed that our problems can be solved and will be solved with the continued good will and spirit of cooperation that has been the cornerstone of our ties over the past four-and-a-half years.

As a Republican Member of Congress, I do not presume to speak for the Administration in defense of its foreign policy. However, from first hand knowledge in my capacity as a member of the House Foreign Affairs Committee, I am certain this Administration has regained the respect and confidence of our friends and allies around the world.

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DEPARTMENT OF JUSTICE,
COMMISSIONER OF IMMIGRATION,
Washington, DC, July 9, 1985.

Hon. ROBERT J. LAGOMARSINO,
U.S. Congress,
Washington, DC.

DEAR BOB: I read with interest your recent editorial comment in the Los Angeles Times regarding U.S.-Mexico relations. My commendations to you for a very well done article.

You are correct that we have had extensive discussions with Mexican officials regarding many matters. In the immigration area I had a series of meetings with Mexican executive and legislative branch officials in February 1985. These meetings were arranged by Ambassador Gavin and we look forward to ongoing and regularized discussions on immigration with Mexican officials. Immigration issues, of course, tie in very closely with those relating to drugs, organized crime, economics and other matters.

We look forward to working with you and the Foreign Affairs Committee to continue our good working relations with Mexico and also to pursue candid discussions of important issues facing our two counties.

Best regards.

Sincerely,

ALAN C. NELSON,
Commissioner.

Mr. BARNES. Does the gentleman from Ohio have any comments to make?

Mr. DEWINE. No, Mr. Chairman.

Mr. BARNES. The gentleman from Arizona, Mr. McCain.

Mr. MCCAIN. Thank you, Mr. Chairman.

Thank you, Governor Babbitt.

I would like to thank the chairman for calling this hearing regarding the United States-Mexican relationship. The role of a stable and prosperous Mexico in maintaining long-term American security interests has been ignored for too long and given too little credence. I believe that Mexico is the single most important country to the United States. Serious instability in Mexico, with its virtually inevitable negative consequences for the United States-Mexican relationship, could force our Nation to drastically reevaluate its entire foreign policy. Our commitments to Western Europe and the Middle East would certainly be affected. We must do all we can to guard against these events.

MEXICO'S ECONOMIC PROGRESS IS KEY TO STABLE UNITED STATES-MEXICO RELATIONS

Economic progress in Mexico is key to a stable United States-Mexico relationship. The economic futures of our countries are inextricably intertwined: A healthy Mexican economy positively affects the U.S. economy and vice versa. Just as important, a healthy economy leads to political stability on both sides of the border. A productive and extensive indigenous Mexican industrial sector, a mature and independent Mexican public economic policy, a productive and prosperous Mexican labor force—all these goals are in the interest of the United States and its neighbors.

However, now more than ever, an interventionist or paternalistic attitude on our part would be entirely out of place. As a vanguard economy among the newly industrializing countries, Mexico deserves the respect and the responsibilities given other well-managed western economies. I believe this perspective characterizes the

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approach of the administration of President Reagan to United States-Mexico relations. In fact, the importance this administration places in the relationship between our two countries was demonstrated, as just mentioned by my colleague from California, as President de la Madrid of Mexico was the first foreign leader received by then President-elect Reagan. I believe this view should characterize this hearing as well.

MEXICO'S EXTERNAL DEBT

As we explore the issues of Mexico's international debt, its demographic impact on the United States and the condition of the United States-Mexico border economy, we should do so in a collegial spirit. We should avoid the partisan rhetoric which so often afflicts the conduct of our foreign policy.

Our concern over Mexico's international debt has been sidetracked as has the entire international debt debate. The repayment of basic public obligations should not be the major issue. Debt is nothing more than the other side of the coin of capital formation. Any well-managed public sector, and, in fact, any well-managed business, must borrow in order to invest in productive capital. Early in our country's history, the railroads and the western land developments were built on debt, most of it owed to European financiers. And, of course, our Federal Government continues to borrow. Repaying this basic public debt is not of central importance, but servicing that debt, paying interest, and meeting schedules, is essential.

This is the point at which many lenders and participants in the debate have been sidetracked. They did not ask at the beginning, and they are not asking now, whether funds loaned to Mexico are being invested in productive assets and infrastructure so as to allow debt servicing. That question should be asked of all borrowers, even our own Government.

Another question we have not asked is whether at some point it would be possible to role over a part of Mexico's debt to Mexican lenders, so that public debt servicing would benefit the local economy. In the wake of the capital flight accompanying the international debt crisis, such a transfer would now be nearly impossible. An international suprabank might accomplish the same goals, as might the series of steps recently recommended by Dr. Henry Kissinger for dealing with Third World debt problems. These ideas and related measures have been placed before the international financial community by U.S. representatives at the IMF meeting in Seoul, Korea. They merit our serious consideration.

MEXICAN MIGRATION TO THE UNITED STATES

Another issue which concerns many of us is that of Mexican migration into this country. Many of the United States' most productive citizens have come from Mexico or are descended from those who did. This group of people is a valued component of our society and especially of that part of our Nation in the State of Arizona. But this coin has another side just as the international debt issue does. Mexico is losing many of its most productive citizens while we are gaining them.

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What most observers of the so-called migration problem overlook is that the most permanent documented Mexican migrants to the United States are professionals, educated and productive members of the society they have left behind. They leave because of unfavorable economic conditions in their home country—perhaps recession or restrictions on investment or the threat of nationalization of assets or simply the lack of means of advancement. It is in Mexico's national interest to alleviate such negative economic conditions and retain many of these productive citizens. I believe that President de la Madrid's recent efforts to liberalize the Mexican economy and make it internationally competitive are moves in precisely that direction, and he deserves our support in these efforts.

Mexican migration to this country has been spoken of in the context of "control of our borders." But here as well the debate should not be sidetracked. Between prosperous and congenial neighbors, border control is not the major problem it is today: To wit, the example of border relations between the United States and Canada. The most favorable development from both the Mexican and United States perspectives is the creation of an economic climate which profitably employs Mexican citizens in Mexico.

All these issues are highlighted in the microcosm of the border economy. My State, Arizona, is a major component of that economy. Arizona financial institutions are among the most exposed in terms of outstanding loans to Mexico. Arizona factories are linked to the Maquiladora or twin plant system of production along the border. Arizona retailers and wholesalers serve the fluctuating consumer demands of Mexican tourists and shoppers. And, of course, our State is a major entry point for Mexican exports to the United States.

A good example of productive United States-Mexico interaction on the border economy is the recent understanding reached between our two countries on the necessity to resolve two potential sources of conflict in the environmental area. The "Smelter Triangle" problem affecting my home State in the Southwest and the sewage problem in the Tijuana/southern California area are now on their way to final resolution.

Obviously, Arizona has a major stake in the issues of United States-Mexico interchange, but so does our entire country. Economic growth in Mexico and equitable distribution of its benefits, and the resultant political stability are items of extreme importance to the United States. Therefore, understanding our countries' interrelationship and those factors which promote economic progress in Mexico in the interest of all of us.

As President Miguel de la Madrid stated when commenting on the Mexican-United States relationship, and I quote:

> Mexico is the initial frontier between the United States and Latin America, the partition between different cultures, each with its own blend of national and universal values. Because of this, the world looks upon our relationship as a test of future possibilities for coexistence between two parts of a continent and between the industrialized world and the developing world.

I would also like to express my appreciation for having two outstanding members who will testify before us, our Governor Bruce Babbitt of the State of Arizona, who is one of the most knowledgeable men in America on United States-Mexico relationships, and

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also Dr. Paul Dickie, Professor of International Finance, who is here from the American Graduate School of International Management.

I thank you, Mr. Chairman, for your indulgence and I appreciate your having this hearing today.

Mr. BARNES. Thank you, Mr. McCain.

As you indicated, we are very fortunate to have with us this afternoon the distinguished Governor of Arizona, Governor Bruce Babbitt, who has, as has been indicated, a unique and extensive understanding of United States-Mexico relations. Our other witnesses this afternoon will be Hon. James Michel, Deputy Assistant Secretary of State for Inter-American Affairs; Dr. Jorge Castañeda, Senior Associate, Carnegie Endowment for International Peace; and Dr. Paul Dickie, Professor of International Finance of the American Graduate School of International Management.

Mr. BARNES. Governor Babbitt, we are particularly pleased you can be with us this afternoon. Welcome to the subcommittee. I look forward to hearing your testimony, sir.

STATEMENT OF HON. BRUCE E. BABBITT, GOVERNOR OF THE STATE OF ARIZONA

Governor BABBITT. Mr. Chairman, thank you very much. I appreciate this chance to appear before you. I want to acknowledge the involvement of Congressman McCain in the work of this committee and his role in bringing this issue of Mexico to the forefront, something that is long overdue, in my judgment.

Mr. Lagomarsino, in response to your comments, I would simply say that I stand by all of the comments that I made in that L.A. Times article. I believe they are all merited and my criticisms are accurate and important.

With that, let me say that I did not come here to plough that ground again, and I will, in the spirit of this hearing, attempt to be less adversary and hopefully more insightful of the problems of Mexico. I will also keep in mind Congressman McCain's admonition that, indeed, this relationship is of such importance that we really must have a bipartisan view, and I would certainly concede that there has been a long history of neglect, misunderstanding, of wrong-headed policies—and there is adequate blame to be apportioned in all quarters.

I hope and believe that the tragic events of the last month in Mexico, the earthquake, will shock Americans into recognition of the importance of this relationship, of the deep political, economic and social crisis within Mexico and the need for understanding and affirmative economic and political policies on our part.

Even in Arizona, I am frequently asked why is it that Mexico is so important? There seems to be an axiom of American politics that the closer the country the less the concern, the deeper the assumption that mere proximity to the United States, a common border, a common position on the North American Continent is somehow assurance that there really is not much to worry about.

Why worry about Mexico?

The land mass of that country is larger than all of Western Europe, with a 2,000 mile border on our south. The GNP of Mexico

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is greater than that of every single country in Central America combined, and you can throw in Argentina on top. Mexico has four times the population of El Salvador, six times the population of Nicaragua. There are more people in Guadalajara than there are in all of Nicaragua. Last year Mexico pumped more oil than Saudia Arabia. Mexico is our third largest trading partner. We do more trading with Mexico than we do with England, Germany, or France. Those are facts that are not commonly understood.

I would submit we fail to understand them at our peril. I believe that there are three major, systemic economic and political issues that deserve the attention not only of this committee and the executive branch but of the U.S. Congress generally. They are the debt, international trade and some emerging understanding of the international and foreign policies of Mexico and the United States.

As we move beyond specific issues, be they of trade, immigration, drugs, we will be back upon the bedrock of these three again and again and again.

MEXICO'S FOREIGN DEBT AS AN IMMEDIATE ISSUE

The debt is the most immediate issue. Mr. Volcker in 1982 did a superhuman job of intervening to save the Mexican financial and fiscal system. Since that time we have been treading water. Nothing has improved. President de la Madrid imposed austerity measures on that country which have dropped the standard of living and the capital purchasing power of the Mexican people by 30 percent. I spoke with him last spring, and he looked me in the eye and said.

> Could Americans endure that kind of relative decline in purchasing power? How long do you think we can keep this country together in the face of those kinds of austerity measures?

Mexico has been, by and large, a model debtor. But 3 years later we have not advanced at all, and I think it is time for this Congress and American leaders generally to understand the reality of that debt. That debt in its current form cannot be repaid without plunging Mexico into economic and social disintegration, and it is time that we, as Americans, in our fiscal and banking and political systems face up to that reality. It is going to require, I think, strong and novel measures and it is going to require the participation of this Congress. It may involve rescheduling, but it will certainly involve more. It may involve converting interest into principal, forgiving part of the indebtedness, examining reactions of President Garcia in Peru who has very understandably said, "We cannot devote all of our foreign exchange to debt repayment, thereby freezing internal development." I believe that principle applies to Mexico as well.

It may be that the debt can be restructured in the form of bond indebtedness through international agencies. It may be it can be swapped for equity, for example, oil to fill the Strategic Petroleum Reserve. But above all, it is essential that we recognize we cannot continue to buy time and to pretend that that debt in its current form can be repaid in normal course. Those days are gone, and that earthquake, I believe, has put that mindset into history.

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UNITED STATES-MEXICO TRADE RELATIONS

Now, related to the debt issue is trade. I think everyone understands that any compromise or rearrangement of that indebtedness must involve reciprocal commitments to the development of Mexico and its international trade.

Our trade relations with Mexico are in very bad shape. Since Mexico opted not to join the general agreements on trade and tariffs, our policy to Mexico has been one of neglect and, indeed, discrimination. Our trade policies are more liberal with respect to most Third World countries than they are with respect to Mexico. Now, the administration in fairness extended the injury test under the GATT codes to Mexico several months ago, but we still do not have a basic bilateral trade agreement with Mexico, our third largest trading partner. We do not have a bilateral trade agreement. I submit that in large measure that is due to lack of initiative on the American side. The spectre of protectionism weighs very heavily upon our relationship with Mexico. The Bentsen-Gephardt bill, which raises the possibility of countervailing duties because of trade imbalances, does not on its face apply to Mexico this year. If passed, it could in the future. It would create, I believe, a disaster. There are bills pending before this Congress which relate to upstream energy subsidies. Any of those bills, which would impose countervailing duties which are based upon an economic analysis of the cost of energy to Mexico, would be a tragic mistake, and I would urge this committee to step into the fray over protectionism with the following message.

Measures aimed at industrialized countries such as Japan ought to be carefully separated out from the impact on Third World LDC's with enormous debt burdens who, if denied access to American markets, will fall even further toward that abyss.

POLITICAL RELATIONSHIP BETWEEN MEXICO AND THE UNITED STATES

Last, a word about the political relationship. It is a subject that initially was not first on my agenda as Governor of Arizona. The economic issues are of great importance to our State. But the political relationship has been brought to my attention again and again and again by the Mexicans themselves. They say Americans do not understand the reality of Mexico. They have not been through that museum of intervention in Mexico City chronicling repeated and tragic instances of American intervention over the last 100 and 150 years. Americans do not understand that Mexico must have its own foreign policy. The modus vivendi between Mexico and the United States has allowed our differences, by and large, to be worked out fairly well over the years. Mexico comes to Latin America, Central America, Chile, Cuba, Nicaragua, all these other countries from a different perspective borne of its history, borne of its position in Latin America. And against those differences Mexico, when the chips are down in the East-West struggle, has always managed to be on the side of the United States. The Mexicans are now saying we are drifting toward a foreign policy which says to the Mexicans: "Cry uncle. Be a mirror image of American foreign policy. Be our foreign policy translated into Spanish."

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I believe that in Central America particularly that lack of understanding is going to have grave consequences. It is reflected in our failure to take the Contadora process seriously. I am not suggesting we should adopt Mexico's policy. I am suggesting that it is possible for Mexico to proceed on a separate track and it is possible for the United States of America to respect and support those initiatives rather than simply attempting to stamp them out. I use that example, but there are many, many others that are borne of the differences that Congressman McCain talked about: Culture, history, and language.

In closing, I would simply emphasize my gratitude that this committee is looking into these issues because surely the most important issue in this bilateral relationship is sustained attention, open debate, and some attempt to bridge the language, the culture and the history.

Thank you.

[Governor Babbitt's prepared statement follows:]

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PREPARED STATEMENT OF HON. BRUCE E. BABBITT, GOVERNOR OF ARIZONA

Mr. Chairman and Members of the Subcommittee:

I am honored by your invitation to testify today. Even more, I am heartened by the subject you have set. No question of American foreign policy combines comparable importance with comparable neglect.

I look at Mexico's elemental significance to our security and I see very little to reflect it on the Washington agenda. In helping make a place for it this subcommittee does a real service. I want to note my special regard in this matter for Rep. John McCain, my fellow Arizonan, who requested this hearing. Those of us from the border states have a special responsibility to our neighbor to the south, and perhaps some added perspective as well.

Why worry about Mexico?

* Mexico's land mass exceeds Western Europe's. And it's right on our border -- for 2,000 miles.

* Mexico's GNP tops Central America's combined, with an Argentina to spare.

* Mexico City has nearly twice the population of Cuba. There are more Guadalajarans than Nicaraguans.

* Mexico pumps more oil than Saudi Arabia.

* Mexico buys more of our goods, and sells us more of theirs, than Britain, Germany or France. When Mexico slashed imports in 1982, America lost 200,000 jobs. One in four major U.S. firms felt the hit.

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In short, the political and economic stability of Mexico is nothing less than critical to our continued well-being. U.S.-Mexican relations should rank with U.S.-Soviet and U.S.-NATO relations at the top of our priority list.

If Mexico were now prosperous and comfortably stable, our present policy might pass for benign neglect of a sort. But Mexico is in crisis. The Wall Street Journal, not normally given to melodrama, proposes "Nation in Jeopardy" for a sobriquet. Mexico's jeopardy has built from a constellation of pressures, most of which long predate the recent earthquake. The Reagan administration, with perverse consistency, has compounded those pressures at every step.

I. The Debt

The magnitude of Mexico's debt is staggering, from two points of view.

For the Mexican perspective consider September's earthquake. This calamity -- the worst disaster for Mexico City since Hernando Cortés -- will wind up costing, by present estimates, about $5 billion in reconstruction. That's not quite five-and-a-half months of interest payments on the debt.

Crushing debt has been the pre-eminent feature of the Mexican economy for the past three years. Mexicans have endured a 30% plunge in their standard of living since 1982. We call that "austerity." It amounts, in real life, to bitter and widespread suffering. To take just one example: the diet of the average Mexican, never extravagant, has been squeezed of a third of its meat and eggs and a quarter of its milk.

For the American perspective consider the banks. Several of our financial giants have debt exposure to Mexico equivalent to more than half their shareholder equity. Mexico can make American banks disappear, they point out south of the border. American banks can't make Mexico disappear.

What has been striking about Mexico, for all this leverage, is its responsibility. Mexico has been a model debtor, extending itself even to help arrange Argentina's 1984 bail-out.

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But it does not seem to me that Mexico can carry the burden alone. Before the earthquake it had falling oil revenues to contend with. To that now add a drop in tourism, rising unemployment, serious damage to the nation's infrastructure, and the emotional drain on a population already stretched to its limits.

Somehow or other the costs of readjustment are going to have to be shared. Mexico, in its present parlous state, cannot go on as a net source of capital to the wealthiest nation on earth. I am not prepared to endorse a plan today, but I offer the following as ideas to consider:

* Persuade commercial banks to reinvest debt payments in Mexico, preferably in regions of substantial out-migration.

* Convert part of the debt into long-term bonds.

* Swap part of the debt for assets such as oil.

* Limit Mexico's payments to a percentage of export revenue.

From a certain point of view these may sound like radical suggestions. So too, three years ago, did rescheduling. We need a bold solution because, without one, the boldest of them all -- default and repudiation -- looms larger every day.

II. Trade

It should be obvious that trade is intimately related to the debt question, and therefore to Mexico's prosperity and ours. But this seems to have escaped our protectionists entirely.

Last week's textile bill, a sufficiently bad idea on its own, looks even worse in the context of our interest in Mexico. While not directly damaging to Mexico, the bill suggests a conception of our trade relations which would tear the heart from any Mexican recovery. We are telling Mexico and other developing countries that they must sell us less, and so earn fewer dollars, at a time when their dollar-denominated debt is already more than they can bear.

Other bills now pending would impose countervailing duties against foreign manufactured products merely because

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they are made with inexpensive natural resources. Mexico's chemical industry would be the first to suffer, strangling yet another source of foreign exchange. This is senseless, and incidentally a marvelous example of how protectionist logic ignores secondary costs.

All negative trade balances are not created equal. One trade deficit benefits a poor neighbor struggling to move a mountain of debt. Another benefits a booming economic competitor thousands of miles across the Pacific. Should we really respond to them the same?

Mexicans have an expression, crecer para pagar, "grow to pay." They are right. Only through growth -- and that means growth of non-oil exports -- can they hope to repay their debt. Yet Mexican exports are now dwindling. The earthquake, as I have said, is a handicap at just the wrong time. It would take willful blindness on our part to add another one.

III. The Political Relationship

The Reagan administration has been merely neglectful of the debt and impotent on trade. In our broader political relationship with Mexico it has been positively destructive.

It has consistently badgered and embarrassed the most pro-American, free-market administration in recent Mexican history. And it has done it by deliberate policy. This policy, premised upon resentment of Mexico's independence, aims at inducing President Miguel de la Madrid to be more cooperative with American foreign policy goals. It is nothing less than an assault on a 50-year-old modus vivendi.

On inter-American matters Mexico has traditionally gone its own way -- maintaining relations with Cuba, opposing the Pinochet dictatorship and sponsoring the Contadora process in Central America. This independence has placated the left in internal politics, promoted Mexican prestige in the Third World and given Mexican presidents room to cooperate quietly with the United States.

Disagreement need not impel us to treat a proud and sovereign state like a troublesome subordinate. The heavy-handed manipulation of pressure shows a failure of imagination and an innocence of history, Mexican and American alike.

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IV. A Final Word: The Earthquake and its Aftermath

September's tragedy has made, in one sense, a reprieve for Mexico. The International Monetary Fund has cut back its demands; sudden shock has pulled the populace together; and government may start to look, to its constituents, less like a taskmaster and more like an agent of recovery.

But the reprieve is brittle. The influx of emergency funds could bring both inflation and corruption, and the dispossessed will not remain patient forever. The aftermath of an earthquake, as both Nicaragua and Guatemala attest, is a dangerous time: with enough despair and resentment, the social fabric can eventually unravel.

America can do a great deal to broaden Mexico's margin of maneuver. Where it has counted most -- in finance, in trade and in politics -- we have thus far done too little. It is time to be a good neighbor, both for Mexico's sake and our enlightened own.

Mr. BARNES. Governor, thank you very much for an excellent statement and many very thought-provoking and insightful comments on the situation.

Let me see if my colleagues have any questions of Governor Babbitt.

Mr. Lagomarsino?

Mr. LAGOMARSINO Yes, I have a few.

Governor, I agree with you that our approach to Mexico should be bipartisan, and I appreciate the fact that you did not mention some of the things that appear in your written statement that would at least indicate to me some difference with that approach.

MEXICANS PERCEIVE THAT THE UNITED STATES ADMINISTRATION IS TAKING SIDES IN THE INTERNAL POLITICS OF MEXICO

Let me just ask you one question about your statement in the L.A. Times. Why did you attach so much importance to members of PAN attending the Republican Party convention while you did not say anything about the PRI members attending the Democratic Convention?

Governor BABBITT. Mr. Lagomarsino, the significance of my remarks is the widespread perception in Mexico that this administration is taking sides in the internal politics of Mexico. Now, in the L.A. Times article I actually qualified those allegations, where I thought it was appropriate. The PAN delegates in Dallas were a big issue in Mexico.

Now, if the PRI delegates attended in San Francisco, that is an important and useful fact, but the perception is what I think is important.

Mr. LAGOMARSINO. There would not be a perception that the Democratic Party was taking sides or they did not care?

Governor BABBITT. This is the first time I heard the statement that the PRI delegates attended.

Mr. LAGOMARSINO. What did you just say?

Governor BABBITT. I am not aware that there were PRI delegates in attendance. There may have been.

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Mr. LAGOMARSINO. Sure.

Governor BABBITT. I believe that the National Security Council memorandum and the Heritage Foundation report, the perception that the administration is affirmatively attempting to dictate internal policy in Mexico, is what gives significance to the Panistas in Dallas. The attendance of the delegates itself is probably not terribly inflammatory. Mixed with those other two facts, I think there is reason for caution.

Mr. LAGOMARSINO. You complain about the administration's lack of initiative, and you criticize the administration for being impotent on trade. Yet it is Congress that is pushing restrictive trade legislation, not the administration. As a matter of fact, they are doing everything they can to stop it. I just point that out.

I would also like to say I agree with you almost completely, if not completely, on your statements about trade, with the exception of perhaps that implication. As a matter of fact, if you are looking at the Congressional Record of last week, you will see a speech by me that sounds very much like what you are saying here. I agree that it is extremely arrogant, self-defeating, and very destructive for us to curtail imports from Third World countries, yet expecting them to pay their debts. There is no way they can do it. I appreciate your suggestions on how we might take care of that debt problem. I do not know that all of those are practical measures, but I think they are all worthy of consideration. Certainly we should do something about it because the situation in Mexico and in other Latin American countries, as well as other countries around the world, is very severe. If we do not do something I think it is apparent to those people that we will not only be doing ourselves great economic harm, as well as the Third World countries themselves, but we will be playing right into the hands of Mr. Castro in Cuba who has been doing everything he can to get these countries not to pay their debts at all. So far they have turned down that bad advice from him.

So, again, I want to commend you for your interest even though we might disagree on some of the specifics of who is doing what and how vigorously.

Governor BABBITT. Congressman, No. 1, I stand by every allegation in this statement.

THE NEED FOR A TRADE AGREEMENT

No. 2, the protectionism is certainly coming as much from my side of the political aisle, and I would even accept the characterization that it is a larger problem on my side of the aisle. I believe the main failings of the administration on the trade issues of Mexico have been, one, the foot dragging on the injury test. That is now past us. Bill Brock literally, the week he left office, acted on the injury test. Two, the failure to achieve a bilateral trade agreement I believe ought to be laid by proxy at your feet, and I would urge you in exchange for my admissions on protectionism to write a letter to the President urging that we get that at the top of the agenda.

Mr. LAGOMARSINO. I might just respond to that, that although this was not mentioned in your article, I pointed out in mine, at

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the time the injury test was taken off or was added on, rather, there was a statement issued by both parties that they would be working to negotiate a comprehensive bilateral trade and investment agreement. It is interesting that at the Interparliamentary Conference in Queretaro, Mexico, in June or late May I served on the Economic Committee and we talked about that, and there seemed to be a lack of—how shall I say it—a lack of enthusiasm on the part of the Mexican delegates to even discuss it, but I do think that it needs to be discussed. We do need to reach an agreement because, as you pointed out so well in your statement, trade is important to both of our countries and we have to negotiate such an agreement.

Mr. BARNES. The gentleman from Ohio is recognized.

Mr. DEWINE. Thank you, Mr. Chairman.

Governor, I want to thank you very much for your testimony and assure you that I think everybody, at least on this panel, shares your belief that our relations with Mexico are vitally important. We feel there is not any country more important to the United States than Mexico, and that includes all of us, even those of us from Ohio as well as those of you who are from Arizona.

IMMIGRATION LEGISLATION

You talked a little bit about the immigration question. I wonder if you could comment about the current bill that is pending as far as the immigration reform and also, of course, about last year's immigration bill. What is your position on that?

Governor BABBITT. Congressman, I omitted immigration only, I suppose, out of a sense of weariness. We have been debating this now nonstop since 1978 in the Southwest. I would simply say in summary there is no symmetrically perfect solution short of a totalitarian solution. In a world of imperfect solutions, it is my belief that employer sanctions are inconsistent with the American law enforcement tradition and that they will be ineffectual.

No. 2, that amnesty should be dealt with carefully. Blanket amnesty is simply an inducement to immigration, the peoples of the world understanding that what America does once out of compassion it will do at regular intervals thereafter for the indefinite future. I believe that we can all agree on the need to take much stronger efforts to beef up the border patrol and the various procedures associated with the border patrol and the INS.

MEXICO'S NARCOTICS PROBLEM AND UNITED STATES RESPONSE

Mr. DEWINE. What is your thinking about the steps that have been taken by the current Mexican administration about narcotics problems and maybe you could share with us your perspective as Governor of a border state.

Governor BABBITT. The Camerena murder and the response of closing the border was, I think, totally disproportionate and a drastic mistake. During that same month, an American major was murdered in East Berlin, and the administration's response was to say let's not get excited, let's talk. I had a couple Mexican citizens ask, why is it that when the Russians shoot a uniformed American officer the response is conciliation, and when a friendly border

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country—cooperating in a crackdown on the drug trade—is the site of a murder you close the border?

I think we ought to reflect on the fact that the Mexicans have been cooperative. Our DEA agents are in that country by leave of the Republic of Mexico, which is an extraordinary fact. We should be grateful for what has been done. We should then move in close and attempt to deal with the obvious problems internal to Mexico in terms of their law breakers. They are very real. We cannot deal with them in this sort of petulant way that was displayed last April.

Incidentally, I would convey something the Mexicans say to me time and time again, and that is: "You Americans must recognize this is a supply-side and demand-side problem, and you better start doing something about the demand side in the United States."

Mr. DEWINE. Thank you.

Mr. BARNES. The gentleman from Arizona.

Mr. MCCAIN. Thank you, Mr. Chairman, and, Governor, thank you for, I think, an extremely thoughtful and thought-provoking statement. We are about an hour away from the time I would like to have, but unfortunately we are limited by time and other witnesses.

I think the United States proved, as a result of the earthquake in Mexico, that Americans from all parts of this Nation are ready to give and give with great generosity to the country of Mexico in a time of need. I also believe that that generosity and charity on the part of the American people is not just confined to the tragedy of the earthquake that took place.

MEXICO'S DISBURSEMENT OF LOANS

However, there is the great question, Governor, as I mentioned in my opening remarks, about where the money goes and whether funds loaned to Mexico are being invested in productive assets and infrastructure or, as we have seen in recent articles and media, some of the money never even touched ground from these lending institutions, the IMF and the United States. How do we ensure that additional loans which are going to be called for, I think you and I will all agree, in some fashion or another—how do we ensure that those funds will go really toward the goals that we all seek rather than flowing into Mexico and immediately back out into the banks all over the world, including the United States?

Governor BABBITT. John, I think that is a profound and important question, and I hope you pursue it with the experts from the State Department. I share your reservations, and I do believe that we must, in exchange for future concessions on the fiscal side, get even more deeply into these issues of where the money goes and the fiscal practices within Mexico.

Traditionally it has been a very delicate subject in the bilateral context. That is why the IMF has been so important in these loan discussions. It seems to me what we must do is find some way to construct a triangular relationship which moves such bodies such as the World Bank or the IMF much more deeply into not only the conditions of the loans but the actual disbursement practices. And that is the extent of my wisdom.

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Mr. McCAIN. In a very careful line of trade so we are not interfering with that nation's internal affairs, as you had pointed out.

THE HANDLING OF MEXICO'S FOREIGN DEBT MORE THAN A COMMERCIAL MATTER

I was interested also in your statement that one of the ideas that you felt should be considered is limiting Mexico's payments to a percentage of export revenue. That, of course, is the Garcia 10-percent solution in a different form, and as my colleague from California, Mr. Lagomarsino, brought up, Castro's proposal which has not received any support throughout this hemisphere. I certainly believe President Garcia's proposal has received a lot of attention because the perception not only from the Mexican Government but from the others is that they are on some kind of treadmill they can never get off of if all the revenue they earn from exports simply goes back into banks elsewhere in the world and does not do anything for their economy.

Have you seen a study Dr. Kissinger prepared? I would like your comments on that. Basically he has made the argument this is just too big to be measured in dollars, or cents, or deficit liability ledgers that bankers deal in. It has to be judged in the broader context of national security and international relations.

Governor BABBITT. Mr. Chairman, Congressman, I absolutely agree with that. The premise of the debt negotiations thus far has been that they can be handled as a commercial matter. I think the banks have been particularly insistent on that because of their reserve and accounting problems; 3 years later it now seems, I think, manifestly clear that we are talking about matters of international politics and international security, and inevitably that this Congress must join directly in those discussions, recognizing, as is the case with the agricultural problems in the Midwest and everywhere else, that everybody will have to give in some measure and that the banks will be before you presenting the problems with the give on their side. I think it is now inevitable and that the sooner we join that discussion in this body the more hopeful the resolution of it.

Mr. McCAIN. Thank you, Governor.

Finally, I think one of the most difficult issues we are facing now is what we have seen a tremendous manifestation of recently in the town of Agua Prieta across from the city of Douglas, AZ, because of the perceived dissatisfaction or manifestation of dissatisfaction with the elections which took place. The people of the town, you know as well as I, took over, burned the city hall and there are predictions that this will continue, particularly throughout the country of Mexico.

I simply am at a loss how we can address this problem, but I think the long-term impact of the perceived inability of the Mexican people to really participate in the electoral process could have very serious consequences, and I wonder if you had any comments on it.

Governor BABBITT. Congressman, I do not have the philosopher's stone for that one. I join with you in acknowledging the problem and I express a profound sense of caution about intervening or ap-

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pearing to intervene in their process at the same time that we must and I think should point up the problem.

Mr. MCCAIN. Thank you.

Thank you, Mr. Chairman.

Mr. BARNES. The gentleman from Florida, Mr. MacKay, is recognized.

Mr. MACKAY. Governor, I very much appreciate your statement. I think as always you have been candid and it is not difficult to understand the position you take and where you stand. It is very refreshing. You made some comments in section three about our political relationship with Mexico. In a recent discussion I had with our people who were involved in the Foreign Relations Department, the Department of State of Mexico, they were expressing concerns that we do not seem to be able to see the world from their standpoint. We are not willing to look at them as partners, and we seem to be continually putting pressure on them to, in effect, toe the line with our policy which puts them in an untenable position, as they see it.

It seems to me you are also saying that we may end up with some kind of a mutual relationship in trying to work this debt problem out which really has got to be perceived as our problem as well as theirs.

THE ROLE OF MEXICO IN THE CONTADORA PROCESS

Do you see perhaps the evolution of the Contadora group and that kind of process leading to something broader and, if so, what role would you see Mexico possibly playing in that?

Governor BABBITT. Mr. Chairman, Mr. Congressman, I think our failure to take seriously and support a Contadora process has been in large measure due to our obsession with Nicaragua, which is a very real problem and which is properly not the subject of today's discussion. But I would contend that whatever the outcome in Nicaragua and however that debate with all of its passion and polarizing effect in this Congress, however it evolves, we will in the final analysis need under any scenario a stronger inter-American or inter-Central American process than we have ever needed before. The legacy of lack of resources, of overpopulation, of colonial misrule and neglect is so strong that Central America is going to be a tinderbox for at least half a century. It seems obvious to me that we should be pushing a policy which encourages Mexico and, for that matter, Panama, Venezuela, and Colombia, into a position of regional leadership on political, security, and financial issues. That objective is so important that we should be willing to pay the price of differences, whether on Nicaragua, El Salvador or elsewhere, in order to move Mexico strongly into a position of leadership in that region.

Mr. MACKAY. Thank you.

Thank you, Mr. Chairman.

Mr. BARNES. Governor, once again we want to thank you very much for your willingness to appear this afternoon and to present your views. You have been very helpful, and we are grateful to you.

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Governor BABBITT. Thank you, Mr. Chairman, and committee members. Thank you very much.

Mr. BARNES. We now want to welcome back to the subcommittee a frequent witness, the Honorable James Michel, Deputy Assistant Secretary of State for Inter-American Affairs.

Mr. Michel, I know you have just been in Mexico, so we are particularly interested in hearing your report on what is happening and the administration's proposals for where we go from here. Welcome back to the subcommittee.

STATEMENT OF JAMES H. MICHEL, DEPUTY ASSISTANT SECRETARY OF STATE FOR INTER-AMERICAN AFFAIRS

Mr. MICHEL. Mr. Chairman, thank you very much. It is a pleasure to be before this distinguished subcommittee.

I have a prepared statement which I would like to present for the record.

Mr. BARNES. We will include your entire prepared statement in our record, and you can summarize anyway you feel appropriate.

Mr. MICHEL. Thank you.

My statement seeks to address the various questions that were asked in the committee's letter inviting us to appear at today's hearing.

EFFECTS OF THE NOVEMBER 19 AND 20 EARTHQUAKES

I have, as you say, just returned from Mexico, and I returned impressed by the magnitude of the problems that were caused by the recent earthquakes, but at the same time I returned impressed by the civil spirit being shown by the Mexican people in digging out of that disaster and proud that our country and the people of this country have been able to be good neighbors at a moment of disaster.

The earthquakes that hit Mexico City on the 19th and 20th of September were devastating in both human and material terms, with over 7,000 confirmed dead and 30,000 injured; many more are homeless, and thousands more may have died in buildings but their deaths not confirmed, hundreds of buildings were destroyed and hundreds more were so badly damaged that they will have to be torn down.

The Mexican Government did respond quickly in establishing emergency centers and, in addition to the Government's action, many individuals and private organizations within Mexico engaged in impressive voluntary efforts to rescue the victims.

Donations from private organizations, individuals within Mexico and from around the world have been impressive. We count more than $25 million thus far that has been contributed to disaster relief.

The U.S. Government participated in this relief effort, donating the services of experts, specialized equipment, and personnel. The cost of this assistance is only $4 million, but it has been assistance that was needed, and requested by the Government of Mexico, and it was delivered efficiently, rapidly, and with good effect.

I would like to depart from the discussion of Mexico for just one moment, if I may, and comment on the fact that within the Depart-

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ment of State there was a task force set up immediately which responded to something like 20,000 telephone calls a day, seeking to manage a flood of inquiries about relatives and friends and the offers that were coming in from all over the country for various kinds of assistance. The Office of Foreign Disaster Assistance in AID, an office with which I have not had direct dealings previously, was truly amazing in its ability to respond instantly to requests that we received and to do so in an enormously professional way. And our Embassy in Mexico, caught up in this on the ground, with lots of heroism stories, lots of extraordinary performances by individuals, I think did a truly extraordinary job. And I, with the committee's permission, would like to insert into the record of this hearing the citation that we presented to the American Embassy for the superior performance that was rendered by the Embassy and its staff, both Mexican nationals and U.S. nationals. I do not want to read it, but I would like to insert it.

Mr. BARNES. We will be pleased to have that as part of the record.

[The information follows:]

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PART I - NOMINATION

1. NAME OF NOMINEE (Last, First, Middle Initial)	2. ORG. SYMBOL OR POST
American Embassy Mexico	Mexico
3. PRESENT POSITION TITLE AND GRADE (Group Award)	4. POSITION HELD DURING PERIOD COVERED BY NOMINATION, IF DIFFERENT THAN PRESENT

5. TYPE OF AWARD RECOMMENDED

A. Secretary's Award		C. Distinguished Honor Award	E. Superior Honor Award
B. Award for Heroism	X	D. Superior Honor Award	

6. BASIS FOR AWARD	7. ESTIMATED 1ST YEAR TANGIBLE BENEFITS	8. INTANGIBLE BENEFITS	9. RECOMMENDED AWARD
X A. Special Act			
E. Superior Performance			

10. JUSTIFICATION FOR NOMINATION (Include a citation) on a line statement supporting the achievement that could be used on the honor award certificate)

CITATION: Among natural disasters, an earthquake is the most terrifying -- it strikes without warning, causes incalculable damage, and threatens further devastation in aftershocks. Extraordinary effort is required to avoid panic and confusion, but the staff of the American Embassy in Mexico -- Mexican and American, those assigned permanently and those on temporary duty -- made that effort on September 19, 1985. In the ensuing days, they established order, provided assistance and comfort to the frightened and injured, and kept an anxious world reliably and completely informed of the damage done and the assistance required. This Superior Honor Award is given in tribute to the heroic efforts of the members of the American Embassy in Mexico during a difficult and dangerous time. Their actions brought honor to themselves and to the United States Government.

JUSTIFICATION: On September 19, 1985, an earthquake registering 8.2 on the Richter Scale struck Mexico. Mexico City suffered the most damage: Thousands lost their lives, but many more were injured or buried in collapsed buildings. Communications links with the world were severed, raising fears among relatives and friends of tourists or residents in Mexico City that their loved ones had perished.

Employees of the American Embassy in Mexico were the first to restore communications with the outside world and to report accurate details of the disaster. Teams from the Embassy surveyed the city to locate the most damaged areas, at considerable risk to their own well-being, while others comforted scores of American citizens who escaped harm in collapsing buildings. Still others relayed to anxious relatives and to Foreign Ministries around the world news of relatives and colleagues. Working with the Mexican Government, the Embassy helped establish priority needs, identify available resources, organize search and rescue teams and coordinate delivery of emergency relief supplies. By these heroic efforts, the Embassy staff helped save lives and ameliorate the pain and grief of those injured or left homeless by the devasting earthquake.

The Embassy staff acted with the highest degree of professionalism and compassion during a difficult and dangerous period. In so doing, they earned the respect of their colleagues and the gratitude of countless private citizens around the world. They brought honor to themselves and to the Foreign Service Agencies of the United States Government.

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American Embassy Mexico
(Group Award)

CITATION:

Among natural disasters, an earthquake is the most terrifying -- it strikes without warning, causes incalculable damage, and threatens further devastation in aftershocks. Extraordinary effort is required to avoid panic and confusion, but the staff of the American Embassy in Mexico -- Mexican and American, those assigned permanently and those on temporary duty -- made that effort on September 19, 1985. In the ensuing days, they established order, provided assistance and comfort to the frightened and injured, and kept an anxious world reliably and completely informed of the damage done and the assistance required. This Superior Honor Award is given in tribute to the heroic efforts of the members of the American Embassy in Mexico during a difficult and dangerous time. Their actions brought honor to themselves and to the United States Government.

Mr. MICHEL. As Mexico undertakes the enormous task of reconstruction, we want, as a good neighbor, to continue to be of assistance to the extent desired by the Government of Mexico and the people of Mexico and in ways that are possible for us. The reconstruction costs are not estimated. They will be in the billions. The first priority will be to replace damaged housing units for the homeless, and to rebuild schools and hospitals. The American Chamber of Commerce in Mexico is working to oversee the allocation of funds collected from within the U.S. from States, from local organizations, and from individuals to help in the rebuilding of the schools and hospitals. The World Bank and the Inter-American Development Bank are planning to reprogram existing loans for emergency needs and for housing, and the International Monetary Fund has agreed to provide $300 million in emergency funding. The funds that are presently available from all of these sources appear to be sufficient to meet the short-term needs for the coming months, the remainder of this year.

There are enormous needs that will be longer term and these will have to be identified by Mexico as it develops its reconstruction plans. I think we can be sure that not everything is going to be rebuilt as it was and where it was. There are a lot of questions regarding urban planning, historic preservation, and government decentralization; many individual decisions will be made by private firms and individuals who own property within the affected areas. All of these questions will have to be addressed before a comprehensive plan and a real idea of the order of magnitude can be arrived at.

The executive branch will want to consult closely with the Congress as these plans evolve. We have some preliminary thinking right now that U.S. assistance might concentrate on support for the private businesses, especially small and medium businesses that were damaged by the earthquake, and on technical assistance in training, transfers of modern technology and support for cooperative efforts between voluntary organizations in the United States and Mexico. We are discussing this with the Government of Mexico, and as those discussions progress we will want to come back and discuss the subjects with you in greater detail.

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UNITED STATES-MEXICAN RELATIONS BEFORE THE EARTHQUAKES

Turning to the general subject of our relations with Mexico as they were before the earthquake, I can describe the relationship with four adjectives: Friendly, mature, extensive and, most characteristically, I think, complex. Because we are neighboring countries, our relationship is very complex indeed, and we both work hard at maintaining that relationship. Our two Presidents meet annually as recommended by Mr. Lagomarsino and, in addition, Secretary Shultz meets more often with Foreign Secretary Sepulveda than with any other foreign minister. There is an annual Binational Commission meeting, chaired by Secretary Shultz and Secretary Sepulveda, in which appropriate cabinet officials participate; and an interparliamentary group meeting is held once a year; and more recently the Attorneys General of Mexico and the United States have established periodic meetings.

Now, there are occasional differences of opinion. This is inevitable. We have differences of opinion with all nations, including our closest friends, and the important point about the differences, I think, is not that they exist but that they are discussed candidly and respectfully with a sincere effort to find common ground. I think far more important than the differences is the fact that there is cooperation between the two Governments on matters of mutual concern. I would like to discuss a few of those areas of concern or just touch on them very briefly.

First of all, there is the economic situation which hit Mexico in 1982 as President de la Madrid was about to enter office, and which he faced early on in his administration with massive economic adjustments and a search for emergency assistance to stablize the economy. There was a program undertaken in cooperation with the IMF that in 2 years produced a major reduction in the Government deficit, reduction in imports, rescheduling of debts, and the provision of external financing. The United States participated in this effort, among other ways, by providing a $1 billion advance payment for the purchase of oil for the Strategic Petroleum Reserve and in cooperating with central banks in arranging an $18 and a half billion short-term bridge loan for Mexico.

In addition, we provided extensive guarantees through the Commodity Credit Corporation in all of the recent years since that crisis hit.

As previous members of the subcommittee and Governor Babbitt have mentioned, Mexico's performance in dealing with the debt crisis has been widely-heralded as a model for other debtors and, as also was previously mentioned, Mexican society has paid a substantial price in terms of reduction of purchasing power and per capita income, and increased unemployment.

In 1984, as the situation began to look better with an accumulation of reserves and a surplus, austerity was eased somewhat and some growth resumed, but as this process went into 1985 the problems began to reappear, partly as a result of lower prices for petroleum and a decline in non-oil exports. By mid-1985 inflation was at 60 percent again; trade and current account surpluses were running much lower; and the public sector deficit was higher than in the previous year.

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In July, the Government of Mexico adopted a number of new measures, including a devaluation of the peso, a liberalization of the import regime and a reduction of Government spending which sought to restore equilibrium. Following that the Government of Mexico and the private banks signed a further rescheduling of $48 billion which is about half the debt of Mexico.

That is where matters stood at the time of the earthquake. I would like to go on and hit a couple other subjects and then return to where we are in the post-earthquake environment.

UNITED STATES-MEXICAN ANTIDRUG COOPERATION

Anti-drug cooperation is, of course, a very important aspect of the relationship with Mexico, and I think it is important to recognize that that cooperation between our two countries has been successful. The history of Mexican heroin coming into the United States has seen a dramatic drop from 78 percent of the U.S. market in the early 1970's to about a third of that market in the early 1980's. However, we see increased trafficking of cocaine and some reduction in the effectiveness of the marijuana and opium eradication program. The murder of DEA Agent Camarena in February of this year and indications that there had evolved a widespread corruption in the narcotics field caused the Government of Mexico to reassess where it was in this program and it took some important steps to revitalize its efforts in the anti-drug field. There have been major reorganizations of the police, and anticorruption efforts are underway; a number of officials have been brought to the courts, and efforts are underway to restore the effectiveness of the eradication program. So I think that there has been an impressive performance in recent months on the part of Mexico.

TRADE RELATIONS BETWEEN THE UNITED STATES AND MEXICO

On the matter of trade, we have substantial trade with Mexico. I believe it is the third largest trading partner after Canada and Japan that the United States has. We did conclude—we are very pleased that we were able to conclude an agreement in April of 1985 in which Mexico, in return for phasing out export subsidies, received assurance that there would be proof of actual injury required before countervailing duties would be applied against Mexican exports to the United States. We have been discussing a trade and investment framework agreement and that should be a very useful vehicle for mutually beneficial commerce.

I would like to dispute one point made by Governor Babbitt, which is his suggestion that there was a lack of enthusiasm on the part of the United States side. We are working very hard at that process and will continue to do so. We think this is an important agreement.

Apart from these major issues, there are a host of issues relating to the boundary between Mexico and the United States, a 2,000-mile boundary, and just an enormous web of complex agreements and relationships that arise out of that. I have addressed these in my prepared statement, and I will be prepared to answer questions on them.

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I would just like to mention a few of them now though. These involve environmental cooperation, on questions of sanitation, sewage, air pollution, hazardous substances, the in-bond industries, the Maquiladoras that Mr. McCain referred to earlier; the international bridges and border crossings; and of course an extensive network with respect to customs and transportation. There are many agreements, many frameworks for ongoing deliberations and discussions on these subjects.

FURTHER CONSEQUENCES OF THE EARTHQUAKES

Turning to where we are after the earthquakes, it is, I think, agreed by all that the earthquakes came in the midst of a most difficult economic situation. Mexico will run a balance of payments deficit this year that will be in the range of $3 to $4 billion, and international reserves are falling. There is uncertainty about the future of the financial situation because there is a dependence on petroleum exports for about 70 percent of export earnings and there is also the very high debt of about $96 billion, and these are influenced by two important variables: the price of oil and the cost of money. And there are two statistics which I would like to recite from my statement. Every $1 decrease in the price of a barrel of oil costs Mexico $500 million and every 1-percent increase in international interest rates costs Mexico $800 million. These are enormous sums caused by the fluctuations of those two variables.

The earthquake is likely to cause some further social dislocation within Mexico. There can be expected to be unemployment in some sectors where business has been damaged, although this will be offset to some extent by increased employment in the construction industry as reconstruction efforts begin. There will be some loss of foreign exchange earnings. I think it should be expected in part because of a loss of some exports, because the product is not being produced or the small company may have been damaged by the earthquake. There will be a need for increased imports because some of the items needed in reconstruction will have to be imported, and there is the troubling temporary decline in tourism which is a major foreign exchange earner for Mexico. I might note that I flew down to Mexico last week on a large airplane with very few people on it, and hotels in Mexico City are reporting a very low occupancy rate at a time when there should normally be an increase in tourism at this time of year.

It is important in this regard not to exaggerate the extent of the consequences of this natural disaster. Mexico's overall industrial capacity was hardly affected, and the devastated area in Mexico City is quite small. The majority of the economic costs will be in pesos, to pay for domestically produced materials and labor that a developed construction industry within Mexico is able to provide.

I think there is little likelihood that we are going to see the social abrasions resulting from the earthquakes translated into political instability in Mexico. It is important to recognize that Mexico's institutions are very sound. It is an advanced country with a people and a government who have demonstrated a resiliency and capacity to deal effectively with crises in the past. Economic and social stability can and will be maintained. To do so it is important

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to have the cooperation of the debtor and creditor, the international financial institutions, the banks and the international community, including, of course, the United States, since America is Mexico's immediate neighbor.

The financial community has shown an understanding of Mexico's situation, I believe, by agreeing to a postponement of a $950 million payment of principal on its debt that was due at the end of September. Clearly for the longer term a lot more cooperation and restructuring is going to be needed.

I believe, in conclusion, that the earthquakes, while a terrible disaster, will not in themselves cause a fundamental change in Mexico or a fundamental change in the bilateral relations between Mexico and the United States. I believe that the initial United States response to this tragedy has been appreciated in Mexico and if we take a cooperative and a sensitive approach to longer term reconstruction that also will be appreciated and it should strengthen our bilateral ties.

THE ECONOMICS OF GROWTH AS A MEANS TO COMBAT THE DEBT CRISIS

Far more important than the damage done by the earthquakes for the future of Mexico and the future of our bilateral relations will be the way in which all participants contribute to the process of overcoming the crisis of debt with the economics of growth. Secretary Baker addressed this subject in Seoul and the revised debt strategy which he discussed has been welcomed by the government of Mexico. The success of this strategy will require a determined effort by the U.S. and the other industrialized countries, by the international financial institutions and by the debtor nations. It is far too early to predict whether all of the interdependent parties to this complex process will make the sacrifices and the commitments that success will require. However, it is easy to predict that the consequences of failure would be calamitous for all of us and, therefore, we will have strong incentives to do no less than our best.

Mr. Chairman, that concludes my statement.

[Mr. Michel's prepared statement follows:]

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PREPARED STATEMENT OF JAMES H. MICHEL, DEPUTY ASSISTANT SECRETARY OF STATE FOR INTER-AMERICAN AFFAIRS

Mr. Chairman members of the Subcommittee:

I welcome this opportunity to analyze recent economic and political developments in Mexico and to assess the state of our bilateral relations. This statement is in three parts:

-- The earthquakes of September 19 and 20, 1985.

-- The state of U.S.-Mexico relations before the earthquakes.

-- U.S.-Mexico relations after the earthquakes.

I. THE EARTHQUAKES

I have just returned from Mexico. I knew before going that our neighbors had experienced a tragedy of extraordinary dimensions. I come back impressed by the magnitude of the problems the earthquakes have caused, but reassured by the

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human determination and cooperation they have called forth. I return impressed by the grit and civic spirit of the Mexican people and proud that we have been able to be good neighbors in their moment of disaster.

The earthquakes that hit Mexico on September 19 and 20 were devastating in both human and material terms. Over 7,000 people are confirmed dead, about 30,000 were injured and 50,000 left homeless. Thousands more may have died. Over 400 buildings were destroyed and perhaps 600, damaged beyond repair, will have to be razed. Hospitals were among the hardest hit, particularly by the second earthquake on September 20. The flattened Juarez Hospital, the scene of repeated miraculous rescues of newborn babies, had been a modern, well-equipped facility capable of saving lives, relieving suffering and increasing medical knowledge; today, it is a pile of rubble.

The Mexican Government moved quickly to establish emergency centers to assist the injured and homeless and to maintain the public order necessary for rescue attempts. Countless citizens of Mexico engaged in voluntary rescue and relief efforts. By all accounts, the survivors' efforts to help victims were heroic.

Donations from private organizations and individuals and

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governments from around the world have been impressive. The response reflects the compassion all feel for the earthquakes' victims. An estimated $25 million has been donated by Mexicans and others from around the world for disaster relief.

The US Government participated in the international effort by sending specialized equipment and personnel requested by the Mexican Government. To date, the US government has contributed $4 million worth of materials, specialist assistance and equipment. This includes a $1 million contribution which Mrs. Reagan, on behalf of the people of the United States, gave to Mexican President Miguel de la Madrid for Mexico's national earthquake relief fund.

As Mexico undertakes the enormous task of reconstruction in the midst of increased economic difficulties, the United States, as a good neighbor, is prepared to provide further assistance as may prove possible and desirable.

Reconstruction costs cannot yet be estimated, but will be high, certainly in the billions, to replace and repair damaged housing units; rebuild schools and hospitals and replace lost equipment; repair roads and bridges; and rebuild commercial and governmental offices. The American Chamber of Commerce in Mexico has agreed to oversee the allocation of funds collected in the US for the rebuilding of schools and hospitals destroyed

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by the earthquake. This will be a high priority. Housing, already in short supply before the earthquake, is now critically scarce. The costs of providing food and shelter to the homeless will also be significant.

The World Bank and the Inter-American Development Bank are planning to reprogram a portion of existing loans to help with short term needs and are considering longer term reconstruction loans. The International Monetary Fund has agreed to provide $300 million in emergency funding.

The funding now available from private donations, the international financial institutions, and from the US and other governments, appear sufficient to meet Mexico's short-term needs.

Less immediate needs will have to be identified as Mexico develops its longer-term reconstruction plans. Not everything will be rebuilt as it was and where it was. Questions of urban planning, historic preservation, government decentralization and a host of other issues must be addressed.

The Executive Branch will wish to consult closely with the Congress in the coming weeks, as Mexico's plans evolve, about ways in which the United States can be of further assistance to Mexico's reconstruction effort. Our preliminary thinking is

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that US reconstruction aid might concentrate on support for small and medium businesses damaged by the earthquake, technical assistance and training, transfers of modern technology, and support for cooperative efforts between Mexican and US private voluntary organizations.

II. U.S.-MEXICO RELATIONS BEFORE THE EARTHQUAKE

Relations between the US and Mexico are friendly, mature, extensive and complex. Both countries work hard at maintaining this relationship, as evidenced by the frequent contact between our respective presidents, cabinet officials and elected representatives. Our two presidents meet annually, and Secretary Shultz meets more often with Foreign Secretary Sepulveda than with any other foreign minister; there is an annual Binational Commission Meeting, chaired by Secretaries Shultz and Sepulveda, in which appropriate cabinet officials participate; an Interparliamentary Group meeting is held once a year; and there are constant contacts between other governmental and private entities.

Given the complexity of these relationships and the asymmetry in our societies, occasional differences of opinion are inevitable, but by and large these differences are discussed candidly and respectfully in an effort to find common ground. Cooperation between the governments on matters of

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mutual concern is extensive.

One of the most important elements of our relationship has been US support and encouragement for Mexico's efforts to deal with the severe financial crisis which began in 1982.

President de la Madrid entered office in December 1982, just four months after the onset of that crisis. At that time, the Mexican economy was weakened by a massive foreign debt-service burden, a large public sector deficit, the exhaustion of foreign exchange reserves and triple digit inflation. Consequently, the new Mexican administration was forced to seek emergency assistance and to plan an economic adjustment program to stabilize the economy.

That program, undertaken in cooperation with the International Monetary Fund, under a three-year Extended Fund Facility program, included a major reduction in Mexico's imports (from $24 billion in 1981 to only $8.6 billion in 1983, excluding imports under the border in-bond industries program) a progressive reduction in the government deficit, the rescheduling of Mexico's debts to foreign private banks, and provision of additional external financing. The United States took extraordinary financial assistance measures to help Mexico, including a $1 billion advance payment for oil for the Strategic Petroleum Reserve, Commodity Credit

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Corporation guarantees for US agriculture exports of $1.7 billion in FY 1983 and $790 million in FY 1984; and US cooperation with other central banks in arranging a $18.5 billion short term loan to Mexico.

The results of the first two years of the Mexican recovery program included a strengthening of the balance of payments, an improvement in foreign exchange reserves, a substantial reduction in inflation, and a strengthening of public finances. Mexico's performance in dealing with its debt crisis was widely heralded as a model for other debtor nations.

The society paid a substantial price, however, as the necessary austerity measures affected all socio-economic levels. Real gross national product declined by .5% in 1982 and by 5.3% in 1983. Per capita income dropped 15 to 20%, while unemployment and underemployment increased. In addition, capital investment, the basis for future economic growth, declined drastically.

In 1984, with the accumulation of $7 to 8 billion in foreign exchange reserves, a strong trade surplus of some $13 billion, a current account surplus of $4 billion, and the beginning of recovery in private sector activity, austerity was eased somewhat. GNP growth resumed at about a 3.5% rate, and some improvement in employment occurred. Although GNP

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continued to grow into 1985, a number of problems began to reappear as a result of lower prices for petroleum (which constitutes about two-thirds of Mexico's export income), and a decline in non-oil exports -- resulting in part from the slowdown in the US economy.

Mexico also encountered difficulties in meeting the targets established under the IMF program. A mid-1985 projection showed inflation remaining at 60 percent. The trade and current account surpluses were expected to be much lower than in 1984, and the public sector deficit was predicted to be higher than in 1984. Foreign exchange reserves declined by about 25% in the first half of the year.

In July 1985, the Mexican Government adopted a number of new measures designed to stem the short-term weakening in the balance of payments as well as to accelerate structural reform of the economy. The peso was devalued and placed under a managed float system, steps were taken to liberalize the import regime in order to improve the efficiency of the Mexican economy and the competitiveness of Mexico's non-oil exports; and reductions in government spending, including the dismissal of some 20,000 government workers, were announced. Mexico and the private banks also signed, in July, a multi-year rescheduling of $48 billion in foreign debt.

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These measures seem headed in the right direction. The structural reform measures particularly appear essential to Mexico's efforts to resume sustained, non-inflationary, economic growth and development.

US-Mexico anti-drug cooperation also is an important element in US-Mexican relations, and has been strong and long-lived. Mexico's drug crop eradication program has been one of the world's most successful. For example, Mexican heroin dropped from a 78% share of the US market in the 1970's to about 34% in the early 1980's. Unfortunately, narcotics production has been increasing during the past 2 years while the eradication program was losing some of its effectiveness. In the wake of the murder of DEA agent Enrique Camarena in February 1985, and indications that drug-related corruption had spread widely, the Mexican government took steps to revitalize its anti-drug programs. Police forces have been reorganized to reduce corruption and efforts are underway to restore the effectiveness of the eradication program. The financial cost of the anti-drug program to the Mexican Government is significant, especially in view of its economic difficulties.

In matters of trade, the US and Mexico cooperate closely and continue to seek to reduce commercial frictions. A subsidies agreement concluded in April 1985, for example, helped reduce trade friction and benefited both countries. In

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return for phasing out export subsidies on terms consistent with international practice, Mexico received assurance that proof of actual injury would be required before countervailing duties would be applied against Mexican exports to the US. Discussions on a general trade and investment framework agreement are on-going and, when finished, should provide a vehicle for increased mutually beneficial commerce between our two countries.

The closely intertwined Mexican and U.S. border economies pose a unique challenges for both nations. Over the years our two governments have established a wide range of effective treaties, agreements and arrangements to deal with boundary and water problems, natural disasters, environmental protection and oil spills, housing and urban development, customs cooperation, and border health. The following border concerns receive special attention.

Border Environmental Cooperation Agreement. President Reagan and President de la Madrid signed this agreement in August 1983. EPA coordinates US participation under the foreign policy guidance of the State Department. Working groups on air pollution, water pollution, and hazardous substances have been active. A second annual meeting of the National Coordinators, designated by EPA and its Mexican counterpart (SEDUE), was held in July 1985 to review progress.

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Border Sanitation Problems. Cross-border flows of raw sewage from Mexican border cities have caused concern in California, Arizona, and Texas. The most urgent problem is caused by sewage flows from Tijuana into south San Diego county. This has caused a growing public health problem requiring the quarantine of San Diego beaches. We have urged the Mexicans also to solve sewage problems in border cities like Mexicali, Nogales, and Nuevo Laredo.

In the case of Tijuana, agreement has been reached on the construction of a treatment plant on the Mexican side of the border. The United States has supported financing by the Inter-American Development Bank and Mexico has provided assurances and safeguards that the Mexican facilities will be properly planned, constructed, operated and maintained.

Air Pollution. There has been an air pollution problem in the "Copper Triangle," where the Phelps Dodge plant at Douglas, Arizona, and two Mexican copper plants at Cananea and Nacozari, Sonora, are located along the border. In July 1985, the United States and Mexico agreed on a proposed solution to these problems. Mexico committed itself to the installation of continuous sulfur dioxide controls before expansion of smelting capacity at Canañea. The agreement also stated that the industry pledged to install a sulphuric acid plant at Nacozari by January 1988, which will reduce sulfur dioxide emissions

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from the plant at that location by 95 percent. In turn, the United States promised to ensure compliance at Phelps Dodge Douglas with Clean Air Act provisions as soon as possible but no later than January 2, 1988. Both governments also agreed that interim measures will be applied to monitor and reduce the impact of present emissions.

Hazardous Substances and Toxic Wastes. The technical working group on hazardous materials and waste management has prepared a work plan to address serious problems such as transboundary movement of hazardous substances and ocean incineration of hazardous wastes. The 1983 Border Environmental Agreement provides for joint contingency planning for inland spills of hazardous substances.

In-Bond Industries. The interdependent border relationship is clearly reflected in the Mexican in-bond industry program, called maquiladoras in Mexico. This program involves mainly US-owned, labor-intensive assembly plants operating on the Mexican side. Mexican employment in these plants increased to over 200,000, in 1985 -- a 30 percent increase over 1984. The border industry program is very dynamic. Both governments have encouraged the expansion of these industries.

International Bridges and Border Crossings. In 1982 the US and Mexican governments agreed on improved bilateral

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coordination on international bridges and border crossings. A new land border crossing at Otay Mesa, California was inaugurated in January 1985. A new bridge at Presidio, Texas is expected to be inaugurated in April 1986. In late June 1985 President de la Madrid announced a new border development plan which includes replacement or expansion of bridges at Brownsville, Del Rio, McAllen and El Paso, Texas. The Government of Mexico has invited a US delegation to visit Mexico City to discuss these projects.

Customs and Transportation. Transportation and customs facilitation issues are handled under various mechanisms -- including annual customs conferences. These conferences have made progress on coordinating work hours at the border, reducing delays in border clearances, joint clearance of cargo and improved enforcement cooperation.

Cross Border Trucking. Mexico prohibits US trucks from its highways except in a few selected border areas. Efforts to negotiate reciprocal access have been unsuccessful. Congress has responded by restricting Mexican access to US highways, including 1984 legislation restricting Mexican access to border communities.

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III. BILATERAL RELATIONS AFTER THE EARTHQUAKE

The earthquakes came in the midst of an already difficult economic situation. The country will run a balance of payment deficit this year of about $3 to 4 billion, with international reserves likely to fall by by over 25 percent.

Mexican officials fear that further declines in the price of petroleum, which accounts for 70 percent of the country's merchandise exports and almost 40 percent of its tax revenues, or an increase in interest rates, will further worsen the situation. Every $1 decrease in the price of a barrel of exported oil costs Mexico $500 million. Every one percent increase in international interest rates costs Mexico $800 million over the following year in interest payments.

Despite these difficulties, Mexican officials have reiterated their resolve to meet the country's international debt obligations, to maintain fiscal discipline and to continue the restructuring of the economy.

In addition, the earthquake is likely to exacerbate social dislocations occasioned by the already long-lived austerity program. Unemployment will increase in some sectors because many small and medium-sized businesses were destroyed in the disaster. This will be offset by increased employment in the depressed construction industry. The overall effect on

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employment cannot yet be quantified. Some loss of foreign exchange earnings should be expected. Not only will there be the loss of some export products and an increase in some imports, but there is already evident a temporary decline in tourism, Mexico's largest foreign exchange earning industry after petroleum exports.

It is important, however, not to exaggerate the extent of the economic consequences of this natural disaster. Mexico's overall industrial capacity was hardly affected. The devastated area in Mexico City comprises a zone approximately the size of New York City's Central Park. Damage outside this area is scattered and, for the most part, slight. The majority of the costs of reconstruction will be in pesos, to pay for domestically produced materials and labor.

There is little likelihood that the social abrasions caused by the earthquakes will translate into political instability. Mexico's institutions are sound, its people and government have demonstrated their resiliency and their capacity to deal effectively with crises in the past. The ruling Institutional Revolutionary Party (PRI) will work hard to maintain the widespread, national support it has enjoyed for the past five decades.

Both we and the Mexican Government are convinced that

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economic and social stability can and will be maintained -- with the full cooperation of debtor and creditor governments, international financial institutions and commercial banks. There is willingness to help in the financial community. The private banks have already agreed to postpone, for 6-months, a $950 million Mexican payment on the principal of its debt to the banks. It is apparent that in the longer term the process will require the continuation of economic restructuring measures needed to provide the sustained growth which will allow Mexico to meet its international debt obligations as well as create the hundreds of thousands of new jobs required to keep pace with population growth and maintain domestic peace.

My conclusion, as of today, is that last month's earthquakes, while a terrible disaster affecting many people, will not be a cause of fundamental change in Mexico, and will not fundamentally alter bilateral relations between Mexico and the United States. The initial US response to this tragedy has been appreciated in Mexico. A cooperative and sensitive approach to longer-term reconstruction should help to strengthen bilateral ties.

More important for the future of Mexico and the future of our relations with this immediate neighbor will be the way in which all participants contribute to the process of overcoming

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the crisis of debt with the economics of growth. Mexican officials have urged that a new international effort be undertaken to find a new, less painful long-term approach to the debt issue. The US proposals for a revised debt strategy advanced by Secretary Baker at the annual meeting of the IMF and IBRD in Seoul were welcomed by the Mexican Government. Success will require a determined effort by the United States and the other industrialized countries, by the international financial institutions and the private banks, and by the debtor nations themselves. This will require:

-- the preservation of a market in the United States that is open to the products of the debtor nations, as well as an opening of markets by the other industrialized countries;

-- substantial increased lending by the international financial institutions and the private banks, including cofinancing arrangements; and

-- the adoption by the debtor nations of comprehensive macroeconomic and structural policies that place greater reliance on market forces, generate domestic savings and investment, attract the return of flight capital, and improve the climate for investment and productive enterprise.

It is far too early to predict whether all the interdependent parties to this complex process will make the sacrifices and the commitments that success will require. However, it is easy to predict that the consequences of failure would be calamitous for all of us. Therefore, we will have strong incentives to do no less than our best.

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Mr. MICHEL. I would like also to add to the record, with your approval, the statement made by Treasury Secretary Baker at the IMF-IBRD meeting in Seoul.

Mr. BARNES. We certainly would be pleased without objection to include the statement of Secretary Baker. It is central to the topic that we are discussing this afternoon.

[The information follows:]

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TUESDAY, OCTOBER 8, 1985

STATEMENT OF THE HONORABLE JAMES A. BAKER, III
SECRETARY OF THE TREASURY
OF THE UNITED STATES

BEFORE THE
JOINT ANNUAL MEETING OF
THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK
OCTOBER 8, 1985
SEOUL, KOREA

Chairman Teurš, Managing Director de Larosiere, President Clausen, fellow Governors, and distinguished guests:

It is a pleasure to be here for the 40th annual meeting of the International Monetary Fund and the World Bank. Strong, effective international financial institutions are as essential to our economic well being today as they were 40 years ago.

Our host country, Korea, is a nation whose economic success is surpassed only by its warm hospitality. Korea's market-oriented approach and strong emphasis on private initiative are a lesson for us all.

Foundation for Growth

I would like to focus my comments today on policies for growth within the context of the international debt strategy. Sound policies and sustained, low-inflation growth in the industrial countries must provide the essential foundation for a successful debt strategy, and are a prerequisite for stronger growth in the debtor countries.

The major industrial countries have already made considerable progress in this direction. Two weeks ago in New York the Finance Ministers and Central Bank Governors of the Group of Five industrial nations underscored the progress which had been achieved, particularly with regard to the convergence of economic performance toward sustained, low-inflation growth. They also announced a set of policy intentions that will help to consolidate and extend that progress and to improve and sustain growth for the longer term.

We emphasized, for our own countries, the central importance of reducing structural rigidities, strengthening incentives for the private sector, reducing the size of government, and improving the investment environment. We also rededicated our governments to resisting protectionist pressures that threaten our own prosperity and the opportunities for others. We must jointly accelerate our efforts to launch a new round of trade negotiations within the GATT.

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These industrial nations agreed that the significant progress already achieved in promoting a better convergence of their economic performance had not been fully reflected in exchange markets and that some further orderly appreciation of the main non-dollar currencies against the dollar was desirable. We expressed our willingness to cooperate more closely to encourage this when to do so would be helpful.

This package of measures had an immediate, significant impact on exchange markets which continues to be positive, and reflects the importance of the commitments made.

I am convinced that if each of the major industrial nations fulfills its policy intentions and maintains or improves access to its markets, we will have taken a major step toward more balanced and sustainable growth, while providing a solid framework for improving the debt situation in the developing world.

Strengthening the Debt Strategy

Fellow Governors, it is essential that we begin the process of strengthening our international debt strategy.

Three years ago the international financial community developed a flexible, cooperative, case-by-case strategy to address the debt problem and lay the basis for growth in the debtor nations. In three years:

-- Aggregate current account deficits in developing countries have been sharply reduced from $104 billion in 1982 to $44 billion this year.

-- Growth in developing countries has been restored to about 4 percent, compared to less than 2 percent in 1982.

-- This growth has been fueled by sharp increases in developing nations' exports, including a 21 percent increase in their exports to the United States last year.

These developments reflect improved growth and sharply lower interest rates in the industrial nations, as well as adoption of improved policies within most debtor countries. These policies have been given important support by reschedulings and rollovers amounting to approximately $210 billion, and by net new commercial bank lending.

The international financial institutions have also played an important role in the progress that has been achieved. The IMF in particular has very capably played a leadership role, providing guidance on policies and temporary balance of payments financing, both of which have catalyzed commercial bank flows.

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Despite this progress, some serious problems have developed. A number of principal debtor countries have recently experienced setbacks in their efforts to improve their economic situations, particularly with regard to inflation and fiscal imbalances, undercutting prospects for sustained growth. Bank lending to debtor nations has been declining, with very little net new lending anticipated this year. The sense of increasing reluctance among banks to participate in new money and debt rescheduling packages has introduced serious uncertainties for borrowers, in some cases making it more difficult for them to pursue economic reforms.

These problems need to be addressed, promptly and effectively, by building upon the international debt strategy in order to improve the prospects for growth in the debtor countries. This is an enterprise which will require, above all, that we work together and that we each strengthen our commitment to progress.

If the debt problem is to be solved, there must be a "Program for Sustained Growth", incorporating three essential and mutually reinforcing elements:

- First and foremost, the adoption by principal debtor countries of comprehensive macroeconomic and structural policies, supported by the international financial institutions, to promote growth and balance of payments adjustment, and to reduce inflation.

- Second, a continued central role for the IMF, in conjunction with increased and more effective structural adjustment lending by the multilateral development banks (MDBs), both in support of the adoption by principal debtors of market-oriented policies for growth.

- Third, increased lending by the private banks in support of comprehensive economic adjustment programs.

I want to emphasize that the United States does not support a departure from the case-by-case debt strategy we adopted three years ago. This approach has served us well; we should continue to follow it. It recognizes the inescapable fact that the particular circumstances of each country are different. Its main components, fundamental adjustment measures within the debtor nations and conditionality in conjunction with lending, remain essential to the restoration of external balance and longer-term growth.

We need to build upon the current strategy to strengthen its ability to foster growth. There must be greater emphasis on both market-oriented economic policies to foster growth and adequate financing to support it.

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In essence, what I am suggesting is that adequate financing can be made available through a combination of private creditors and multilateral institutions working cooperatively, but only where there are reasonable prospects that growth will occur. This will depend upon the adoption of proper economic policies by the developing countries. Financing can only be prudently made available when and as effective policies to promote economic efficiency, competitiveness and productivity -- the true foundations of growth -- are put in place. We cannot afford to repeat the mistakes of the past. Adjustment must continue. Adjustment programs must be agreed before additional funds are made available, and should be implemented as those funds are disbursed.

These efforts should be mutually reinforcing. Sound policies in the principal debtor countries will not only promote growth, but will also stimulate the needed private bank lending. And it will be important that these policies be supported by the IMF, complemented by the MDBs. These institutions can help encourage and catalyze both needed policies and financing.

In today's highly interdependent world economy, efforts at economic isolationism are doomed to failure. Countries which are not prepared to undertake basic adjustments and work within the framework of the case-by-case debt strategy, cooperating with the international financial institutions, cannot expect to benefit from this three-point program. Additional lending will not occur. Efforts by any country to "go it alone" are likely to seriously damage its prospects for future growth.

I would like to elaborate on the actions that will be required by each participant in this three-point program.

Structural Change in the Principal Debtors

The essence of the need for structural change in the principal debtors is captured in two quotations I would like to share with you.

First:

> "The only way to overcome our economic crisis is to tackle at their root the structural problems of our economy to make it more efficient and productive." 1/

1/ President de la Madrid at Mexican Bankers Association Annual Meeting, July 22, 1985.

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And second:

> "Economic growth will have solid foundations only if we reestablish trust and stimulate private enterprise, which must be the flagship of our economic development... We will promote authentic institutional change in the economic sector." 2/

These are not the words of a U.S. Secretary of the Treasury. They are statements made in July of this year by the Presidents of Mexico and Brazil. I believe they reflect a growing sentiment in Latin America.

It is essential that the heavily indebted, middle income developing countries do their part to implement and maintain sound policies. Indeed, without such policies, needed financing cannot be expected to materialize. Policy and financing are not substitutes but essential complements.

For those countries which have implemented measures to address the imbalances in their economies, a more comprehensive set of policies can now be put in place, which promises longer term benefits from stronger growth, higher standards of living, lower inflation, and more flexible and productive economies. These must not only include macroeconomic policies, but also other medium and longer term supply-side policies to promote growth.

We believe that such institutional and structural policies should include:

-- increased reliance on the private sector, and less reliance on government, to help increase employment, production and efficiency;

-- supply-side actions to mobilize domestic savings and facilitate efficient investment, both domestic and foreign, by means of tax reform, labor market reform and development of financial markets; and

-- market-opening measures to encourage foreign direct investment and capital inflows, as well as to liberalize trade, including the reduction of export subsidies.

2/ President Barney in a televised address to the nation, July 23, 1985.

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This broader approach does not mean that policy areas that have been the focus of efforts to date -- in particular fiscal, monetary, and exchange rate policies -- can receive less attention. Indeed, macroeconomic policies have been central to efforts to date and must be strengthened to achieve greater progress. These policies should consist of:

-- market-oriented exchange rate, interest rate, wage and pricing policies to promote greater economic efficiency and responsiveness to growth and employment opportunities; and

-- sound monetary and fiscal policies focused on reducing domestic imbalances and inflation and on freeing up resources for the private sector.

The cornerstone of sustained growth must be greater domestic savings, and investment of those savings at home. Macroeconomic and structural policies which improve economic efficiency, mobilize domestic resources, and provide incentives to work, save, and invest domestically will create the favorable economic environment necessary for this to occur. Such an environment is also critical to attract supplemental foreign savings.

As a practical matter, it is unrealistic to call upon the support of voluntary lending from abroad, whether public or private, when domestic funds are moving in the other direction. Capital flight must be reversed if there is to be any real prospect of additional funding, whether debt or equity. If a country's own citizens have no confidence in its economic system, how can others?

There are essentially two kinds of capital inflows: loans and equity investments. Foreign borrowings have to be repaid -- with interest. Equity investment, on the other hand, has a degree of permanence and is not debt-creating. Moreover, it can have a compounding effect on growth, bring innovation and technology, and help to keep capital at home.

We believe that the debtor nations must be willing to commit themselves to these policies for growth in order that the other elements of a strengthened debt strategy can come into place.

Enhanced Effectiveness of the International Financial Institutions

The international financial institutions must also play an important role in strengthening the debt strategy to promote growth. However, we must recognize that the international financial institutions cannot have sufficient resources to meet the debtor nations' financing needs all by themselves. An

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approach which assumes that the IMF and the World Bank are the sole answer to debt problems is simply a non-starter. For most developing countries other sources must play a more important role. These include private sector borrowing, increased export earnings, foreign equity investment, and repatriation of capital which has fled abroad. All these routes should be pursued.

Among the international financial institutions, the IMF has played a major role in advising member nations on the development of policies necessary to promote adjustment and growth. There has been a particular focus on monetary, fiscal, and exchange rate policies, although increasing attention is being paid to other areas such as trade liberalization, pricing policies, and the efficiency of government-owned enterprises.

Emphasizing growth does not mean deemphasizing the IMF. Through both its policy advice and balance of payments financing, the Fund has played a critical role in encouraging needed policy changes and catalyzing capital flows. It must continue to do so. But it must also develop new techniques for catalyzing financing in support of further progress. "Enhanced surveillance," for example, can sometimes provide an effective means of continued IMF involvement.

The Fund should give higher priority to tax reform, market-oriented pricing, the reduction of labor market rigidities, and to opening economies to foreign trade and investment. This will help assure that Fund-supported programs are growth-oriented. It will be particularly important for the Fund to work closely with the World Bank in this effort.

I would now like to turn more directly to the role of the MDBs, which need to be brought into the debt strategy in a stronger way, without diminishing the role still to be played by the IMF.

The World Bank, and indeed all MDBs, have considerable scope to build on current programs and resources, and to provide additional assistance to debtor nations which is disbursed more quickly and targeted more effectively to provide the needed stimulus to growth.

There is ample room to expand the World Bank's fast-disbursing lending to support growth-oriented policies, and institutional and sectoral reform. An increase in such lending can serve as a catalyst for commercial bank lending.

A serious effort to develop the programs of the World Bank and the Inter-American Development Bank (IDB) could increase their disbursements to principal debtors by roughly 50 percent from the current annual level of nearly $6 billion.

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Increased disbursements would require greater borrowing by the MDBs in world capital markets. Their ability to borrow at low rates is a precious asset which must be preserved. Therefore, their lending must be in support of sound economic programs that enhance the borrower's ability to service its debt and grow.

It should be possible, with a concerted effort by both the World Bank and borrowers, to streamline World Bank operations in order to reduce considerably the time period required to formulate and implement such assistance programs. This will expedite the actual disbursement of funds.

The value and role of an indigenous, competitive private sector needs to be recognized and developed more fully than it has in the past. The Bank, for its part, should actively promote the development of the private sector and, where appropriate, provide direct assistance to this sector. In addition, the Bank should seek to assist, both in a technical and financial capacity, those countries which wish to "privatize" their state-owned enterprises, which in too many cases aggravate already serious budget deficit problems.

Given the importance of increasing commercial bank flows to the principal debtors, there is also an urgent need for efforts to expand the Bank's co-financing operations. These efforts should be pursued vigorously to increase the effectiveness of the Bank in helping its borrowers to attract private finance, and should have substantial potential in the context of this three-point program.

The enhanced program of the International Finance Corporation, with an expanded capital base, and the recently negotiated Multilateral Investment Guarantee Agency (MIGA) are two important Bank Group initiatives in support of developing countries. Both organizations can do much to assist their members in attracting non-debt capital flows as well as critical technological and managerial resources. We urge all Bank Members and particularly the principal debtors to give their full support to establishment of the MIGA.

If developing countries implement growth-oriented reform; if commercial banks provide adequate increases in net new lending to good performers; and if increased demand for quality IBRD lending demonstrates the need for increased capital resources, we would be prepared to look seriously at the timing and scope of a general capital increase.

We believe the World Bank's efforts can be supplemented actively by the regional development banks. Since some of the

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most serious debt problems are found in Latin America, special emphasis should be placed on strengthening the IDB's policies to enable it to be a more effective partner in support of growth-oriented structural reform.

In the case of an IDB capital increase, it will be critical to assess the extent to which the institution strengthens its lending policies. There must be well-defined economic and country strategies tailored to enhance economic reforms which encourage growth. Given a firm commitment by the IDB to move in this direction, we believe that it should be permitted to introduce a major program of well targeted non-project lending. In the meantime, such lending could be associated with World Bank programs until the IDB has implemented the necessary reforms.

Increasing Lending by the International Banking Community

The international banking community has played an important role during the past three years. I am, however, concerned about the decline in net bank lending to debtor nations over the past year and a half, particularly those nations which are making progress. All of us can appreciate the commercial banks' concerns, but we believe these concerns would dissipate if the banks were confident that new lending is in support of policies for growth in the developing nations.

If creditor governments, in an age of budget austerity, are to be called upon to support increases in multilateral development bank lending to the debtor nations, and if the recipient nations are asked to adopt sound economic policies for growth to avoid wasting that financing, then there must also be a commitment by the banking community — a commitment to help the global community make the necessary transition to stronger growth.

Our assessment of the commitment required by the banks to the entire group of heavily indebted, middle income developing countries would be net new lending in the range of $20 billion for the next three years. In addition, it would be necessary that countries now receiving adequate financing from banks on a voluntary basis continue to do so, provided they maintain sound policies.

I would like to see the banking community make a pledge to provide these amounts of new lending and make it publicly, provided the debtor countries also make similar growth-oriented policy commitments as their part of the cooperative effort. Such financing could be used to meet both short-term financing and longer-term investment needs in the developing countries, and would be available, provided debtors took action and multilateral institutions also did their part.

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We would welcome suggestions from the banking community about arrangements which could be developed in order to ensure that adequate financing to support growth is available.

The Poorest Countries

Before concluding my statement, I would like to focus briefly on the problems of another set of debtor countries, the low-income debtors with protracted balance of payments problems. Special efforts are being made to assist these countries, but more can and should be done to improve their longer-term prospects.

The United States believes that the resources provided by the Trust Fund reflows provide a unique opportunity to help address the economic problems of the poorest countries with protracted balance of payments difficulties. Recent experience demonstrates that successful resolution of the economic problems of these countries requires a comprehensive approach, including fundamental structural policy changes, as well as sound macroeconomic policies.

The $2.7 billion in Trust Fund reflows present us with an opportunity to utilize IMF resources, possibly supplemented by funds from other sources, in support of such comprehensive economic programs. The effectiveness of such programs would be enhanced by close cooperation between the Fund and Bank. In some cases, this could best be accomplished by a joint approach by the two institutions in support of comprehensive programs.

The United States is also prepared to consider a bolder approach, involving more intensive IMF and World Bank collaboration. We believe that this approach would help ensure that the institutions provide sound, mutually consistent advice on the full range of policies to promote growth.

The United States, which supported African countries with $1.7 billion in bilateral aid in 1985, would be prepared to consider seeking resources in support of such a far-reaching approach if other donors were prepared to make equitable contributions.

We recognize that some may have reservations about such an approach, viewing it as complicated and difficult to implement. I can understand some of these concerns, and believe they suggest the need for further reflection on certain aspects of this proposal. But, we cannot let parochial resistance or unfounded suspicions block an idea that can significantly help the poorest countries and strengthen ties between the Fund and the Bank. I urge you to give this approach further consideration during the months ahead.

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Conclusion

In conclusion, much has been accomplished in the past few years in addressing the pressing economic problems of the early 1980s and preparing the foundation for future global growth. We must now join together to consolidate our progress in building stronger economies for the future.

Sound policies and growth in the industrial world can provide a solid foundation for strengthening and adapting the current international debt strategy. Let us not lose the present opportunity. I have proposed a three-point "Program for Sustained Growth" to provide renewed impetus for resolving the debt problem. We must not deceive ourselves. There are no easy solutions, and none of us can escape our responsibilities.

The principal debtor nations must make the hard policy decisions to restructure their economies. The commercial banks must provide adequate resources to support these efforts. The MDBs must increase the efficiency and volume of their lending.

Moving from proposal to implementation will be a demanding exercise and cannot be accomplished overnight. As we adapt our strategy, we must continue to look to the IMF as the catalyst for new financial flows. And with these new flows will come new hope.

We will be building on the efforts of the past. The needs are clearly recognized by borrowers and creditors alike. Fundamentally, there is no disparity of interest among our nations. We have a common interest in growth — sustained growth that rests on productivity, innovation and investment. Let us begin our efforts now.

Mr. BARNES. I was interested in your comment that the Mexicans look with favor upon Secretary Baker's statement. Do they, in your judgment, view it as adequate to respond to their needs and to the needs of other debtor nations?

Mr. MICHEL. I think we are just at the beginning of discussions, serious discussions, that we are going to have to have with Mexico and the other debtor countries, and I think it would be premature for me to express a general yes, everything is fine. I know everything is not fine.

Mr. BARNES. I would be surprised if they did.

THREE PRINCIPAL ELEMENTS OF A GROWTH-ORIENTED ECONOMIC POLICY IN DEVELOPING NATIONS

Mr. MICHEL. I would say the three principal elements of this revised approach are that, first of all, it is a recognition that there must be growth in the economies of the countries that are paying these debts so that they are not faced with austerity year after year. The debt, which is a fixed amount, becomes more manageable in a growing economy than in a static economy. It calls upon the developed countries to maintain open markets and trade with the developing countries, to support the international lending institutions which themselves need to take a more active role in structural adjustment lending and sectoral lending for providing the additional resources that are needed to achieve growth, and it calls on the private banks to increase their lending as well.

In exchange, it asks of the debtor nations that they attend to the macroeconomic and structural policies that would place greater re-

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liance on market forces and generate savings and investment, attract the return of flight capital and improve the climate for productive enterprise.

I could add one quote which I think is indicative of a consensus on the part of the government of Mexico with the need for greater efficiency and productivity, and that is a statement which President de la Madrid made in July in which he said, "The only way to overcome our economic crisis is to tackle at their root the structural problems of our economy to make it more efficient and productive."

I think with that outlook and with the willingness of the other participants to play their part, that the proposals made by Secretary Baker hold a lot of promise for moving forward from this austerity, without seeing the growth that is necessary to come behind it, to providing the resources to debtor countries that are taking the structural adjustment measures so there can be growth and stagnation can be overcome.

Mr. BARNES. I hope that your analysis is right. I have not had a chance to read in detail Secretary Baker's proposals. I have read the newspaper accounts of them. They seem to place a fairly heavy reliance on the willingness of the private banks to undertake additional steps on their own to help, and I do not know whether that is going to be forthcoming. I think it is in their own interests and I hope they understand it.

Mr. MICHEL. It is my understanding that—and I am getting far afield from my own expertise here—there have been some discussions of senior people in the financial world who do see it as in their interests to cooperate and do their part, if others also do their part, so there can be progress in dealing with this very difficult issue.

Mr. BARNES. I hope so. It is an enormously important issue for all of us in the hemisphere, and I thought you laid it out well. I think Governor Babbitt was right when he said we need to understand that it is our problem and not just their problem. It is a collective problem, and it is encouraging for those of us who have been shouting about this for years to see Secretary Baker and yourself and others in the administration addressing this in a concerted way.

We have other witnesses after Mr. Michel, so we will operate on the 5-minute rule.

Mr. Lagomarsino.

Mr. LAGOMARSINO. Thank you, Mr. Chairman.

MEXICO'S STEPS TO REPAY THE EXTERNAL DEBT

I gather from your statement, Mr. Michel, that it would be your position that prior to the earthquake the Mexican Government had demonstrated willingness to live up to the reforms recommended by the IMF and others, that they were doing that.

Mr. MICHEL. Mexico was operating under an agreement for the first several years after 1982 and had gone out of compliance just—there was a press release about their going out of compliance just the week of the earthquake. But the position of Mexico on working with the international financial institutions is a positive one.

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Mr. LAGOMARSINO. The Mexicans have not latched onto the suggestions of Fidel Castro?

Mr. MICHEL. No, sir.

Mr. LAGOMARSINO. I guess nobody else has either.

Mr. MICHEL. I think it is pretty clear when you get beyond the most superficial analysis that to achieve growth in the economies of the countries of Latin America capital is required. Countries do not attract capital by refusing to pay their debts. They scare it away; and it is seen, I think, by virtually all the countries of Latin America that the suggestions made by Mr. Castro are not serious suggestions, especially since he does not follow those suggestions himself and goes to the Paris Club and seeks rescheduling, and promises to be a good debtor and pay his debts.

Mr. LAGOMARSINO. In your opinion what are the prospects for Mexico to open up its economy further to foreign investment?

Mr. MICHEL. I think that the issue is receiving serious attention within Mexico. There are in that complex society a lot of different points of view, but we have seen that the businesses that have remained there, the private businesses with American investment, have done all right within the Mexican economy, that there have been some new investments approved, I think most notably, not for its size but for the terms of the investment, the IBM facility where the Government of Mexico allowed it to come in with 100 percent ownership. There were some questions of the rules of the game for various sectors of industry, such as in the pharmaceuticals area some time ago, which were resolved. I think on the whole a serious look is being given by Mexico to new investment proposals. The Government of Mexico itself recites, I believe, $1.5 billion last year in new investment. So I think there is generally a cautious but open willingness to look at new investments and an openness to investment.

Mr. LAGOMARSINO. I got the impression in late May when we were in Queretaro at the Inter-Parliamentary Conference that the government, as distinguished from the legislature, was moving or was willing to move in the direction of "freer trade" than had been the case prior to that. But that the legislators either had not gotten the message yet or were doing as legislators all over the world do, I guess, including here, posturing for their constituents. Do you get that impression?

Mr. MICHEL. I do not think there is that clear a distinction between the executive and legislative branches. I think that there are a variety of views on this subject. I am sure that there are some sectors of American society that would advocate protectionism for their industry as we see from debates in this country about the virtues and evils of protectionism that cuts across lines of government, private sector, legislature, executive. I think on the whole there has been a more positive, open attitude toward investment within Mexico as a trend. But you—it is sort of a case-by-case approach.

Mr. LAGOMARSINO. As a matter of fact, I found it rather interesting because at prior meetings the views of the legislature and executive were identical. As a matter of fact, it often appeared to us that the executive was furnishing the statements and so on for the legislative. So I thought that was very interesting.

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Mr. BARNES. The gentleman from Ohio.

Mr. DEWINE. Thank you, Mr. Chairman.

Mr. Michel, you stated in your testimony one of the things you think Mexico should do would be to have policies that have a greater reliance on market forces. I note in Governor Babbitt's prepared statement he states on page four, and he is talking about this administration, "It has consistently badgered and embarrassed the most pro-American, free-market administration in recent Mexican history."

With that as a kind of a lead-in, I wonder if you could tell me what your opinion is. Are you optimistic or pessimistic or neither one about the prospects for the current Mexican Government moving more towards free market policies?

Mr. MICHEL. That is a little bit like the previous question about investment. I think, as I say, there is—this is a controversial subject within Mexico with a lot of different points of view being expressed. I am hopeful—I won't say I am confident, but I am hopeful that the views expressed by President de la Madrid about the need for having a structure that will support growth will cause Mexico to conclude that market-oriented policies are the way that you can achieve growth in your economy, that you cannot legislate economic growth. So that is more a hope than a prediction. I must decline, I think, to make a prediction. But certainly there are senior people within the Government of Mexico, there are senior people within the business leadership in Mexico, who favor a more market-oriented approach.

MEXICAN COOPERATION ON NARCOTICS PROBLEM

Mr. DEWINE. Moving to the question of narcotics, on page 9 of your testimony you state, "Unfortunately, narcotics production has been increasing during the past 2 years while the eradication program was losing some of its effectiveness." I hope I am not taking that out of context. Would you expand on that a little bit?

Mr. MICHEL. I think we and the Government of Mexico, having engaged in this cooperative program for a long time, stopped watching it as closely as we did at the outset, and I think that the eradication effort simply was not pursued with a consistent vigorous application that would allow it to continue to cause the production to decline. I think that, as the statement goes on to say, we have engaged in discussions more recently with the Government of Mexico and it has taken positive steps which are encouraging, and I will make a prediction there. I think we will see more effective cooperation on the narcotics front.

Mr. DEWINE. Thank you, Mr. Michel.

Thank you, Mr. Chairman.

Mr. BARNES. Mr. McCain.

Mr. MCCAIN. Thank you for your testimony, Mr. Secretary.

I do not share your confidence in the political stability, but I certainly appreciate what you have to say and particularly in the Northern States that are experiencing difficulties that we heard discussed earlier. I would just like to clear up someting.

On page 11 you talked about the very important issue to really all of the Southwest, and that is the air pollution problem, the so-

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called Copper Triangle. You stated, "Mexico committed itself to the installation of continous sulfur dioxide controls before expansion of smelting capacity at Cananea." You also stated that "* * * the industry pledged to install a sulphuric acid plant at Nacozari by January 1988." Does that mean that they will not remit between now and January 1988 or does that mean that they will begin operation and have SO_2 emissions between now and January of 1988?

Mr. MICHEL. I think it is the latter. Yes, I understand that they will be operating before that is installed.

Mr. MCCAIN. On the next page you say, "In turn, the United States promised to ensure compliance at Phelps Dodge Douglas with Clean Air Act provisions as soon as possible but no later than January 2, 1986."

Mr. MICHEL. I knew when I saw it—that is the only typographical error I am aware of in my statement, sir, and I was afraid I would get that question. I would like to take this opportunity to correct the error in the statement, that that should say January 2, 1988.

Mr. MCCAIN. Thank you very much.

Thank you, Mr. Chairman.

Mr. BARNES. Mr. MacKay.

Mr. MACKAY. No questions.

Mr. BARNES. Mr. Michel, thank you again very much for appearing before the subcommittee this afternoon. We appreciate your willingness to give us that up-to-date report.

Mr. BARNES. Next we have Dr. Jorge Castaneda, senior associate, Carnegie Endowment for International Peace; and Dr. Paul Dickie, professor of international finance, the American Graduate School of International Management.

Gentlemen, we welcome you to the subcommittee. We appreciate your patience.

Mr. BARNES. Dr. Castaneda, would you want to lead off. We welcome you this afternoon.

STATEMENT OF JORGE G. CASTANEDA, SENIOR ASSOCIATE, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

Mr. CASTANEDA. Thank you, Mr. Chairman.

I would like to, of course, thank you and the subcommittee for your invitation to testify here. It is not often that I find myself directly speaking to American lawmakers.

I have submitted a prepared statement which includes a section on Mexican foreign policy and another one which includes the analysis of the situation in Mexico today on the domestic and economic fronts, and I would like to sum up those two statements in my brief statement here.

To begin with, I would like to take this opportunity to thank the Congress, the people, and the Government of the United States for the assistance extended to Mexico in its hour of trial. I hold, of course, no representation of any sort, but I do know that my countrymen share this feeling of gratitude to the United States.

Mexico was in very serious straits before the September 19 earthquakes. The most devastating natural disaster in the country's history has simply made an already critical situation much worse.

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Indeed, the country's current crisis is probably its gravest since the revolution at the beginning of the century. Although the most immediate problems are clearly emergency relief for the approximately 120,000 left homeless in Mexico City, and the reconstruction of the capital's destroyed infrastructure, Mexico's overriding concern continues to be its $96 billion foreign debt.

MEXICAN DEBT DILEMMA: PAY OR GROW

Three years of drastic austerity which have brought a reduction of nearly 50 percent in most wage earner's purchasing power have made one fact very clear: Mexico can either go on paying the $12 to $13 billion per year to service its debt or it can pursue a growth-oriented economic policy creating the approximately 800,000 new jobs per year the country needs. It cannot do both.

Late last year, after 2 years of negative economic growth, the Mexican economy began expanding at its traditional 6 to 7 percent yearly clip. Practically overnight imports skyrocketed, exports stagnated and the country's trade surplus, with which the interest on the debt is paid, shrank by 48 percent over the first 7 months of this year in relation to last year.

By July of this year, Mexico's dilemma was painfully obvious: pay or grow, either or.

Given the present structure of the economy and given that new loans, even if they were available and that is a doubtful proposition, imply new interest to be paid, the conclusion is all too evident. There is no long-term solution to Mexico's debt crisis yet in sight.

Recent proposals or new strategies are merely quick fixes which do not address the key issue. Mexico continues to require external financing because of a chronically depressed savings rate, but it cannot pay interest [illegible] alone reimburse the principal on what it has already received. All the headlines and media hype in the world are not going to transfer short-term relief into long-term solutions.

On the political front, austerity, negative economic growth, and now the earthquake have taxed an aging political system badly in need of renovation. Widespread, although certainly not massive, discontent stems from a characteristically Mexican phenomenon. The Government and political establishment have always been viewed by most Mexicans as widely corrupt and inefficient. This, however, was forgiven for many years because the same political system produced nearly 50 years of economic growth and political stability.

The former has disappeared. The latter is still with us, but is probably not enough. Nor can that famed political stability continue to be taken for granted although it is certainly not presently threatened. In fact, the absence of any viable alternative to the existing system is both its strength and its weakness.

The left is honest and well intentioned but marginal. The right is vociferous and extreme, but has a greater stake in the status quo than anyone else in the country. So when elections are held, the PRI, the ruling party, continues to rack up impressive vote totals. The fact that they are in many cases inflated by electoral fraud

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and that Mexico's greater international exposure has made this fraud more apparent does not change the face of the equation. No opposition means no alternative but, in turn, makes the system less responsive and more isolated, thus feeding the growing unchanneled and unexpressed discontent.

These problems, both economic and political, have been compounded by September's earthquakes. Reconstruction costs have not yet been fully estimated, but several billion dollars is an adequate ballpark figure. Rebuilding housing for the homeless, repairing the severely damaged drinking water system, replacing destroyed telecommunciations and medical facilities all require resources which the country barely has. The three available options, printing press, new loans, or more austerity, are all nonstarters but will, nonetheless, have to be combined in as judicious a blend as possible. For the political consequences of not doing anything are far worse than any presently conceivable economic cost.

The quakes political effects in that sense will in the long run outweigh the economic ones. In the political and organizational void left by the Government's logical and inevitable paralysis immediately after the tremor, Mexican society took over. For the first time in years Mexicans were able to take matters, in this case relief and rescue operations, into their own hands and, more importantly, were able to perceive the difference their actions could mean. Apathy and cynicism, even for a few days, were laid aside and society rediscovered forgotten virtues. It was also discovering the well-known, often-described but often ignored vices of a political system which had never showed its weakness in public. In the aftermath of the earthquake most things have returned to their normal ways. President De la Madrid's administration, initially overwhelmed by the magnitude of the disaster, has regained control of the situation, but clearly things in Mexico are going to have to change if the system and the country are to survive.

A TRUE DEMOCRATIZATION OF POLITICAL INSTITUTIONS IS NEEDED

One key condition must be met in order for Mexico to emerge from its turmoil as a better and stronger country. The condition is a true democratization of the country's political institutions. Decentralization, greater honesty and efficiency in public matters are important, but they will only come and last if they are imposed and made to stick by society at large.

Mexico is not a dictatorship nor has it been so for years, but it is certainly not as democratic a nation as it should be nor as its inhabitants want it to be. Before the September tragedy there was an urgent need for more democracy. Now Mexican society is clamoring for it with growing impatience. But democracy, and modernization, require money and Mexico has very little of it.

Unquestionably, the country needs aid from abroad and particularly from the United States. Water, telecommunications, hospitals, and schools have been designated as the priority areas by President de la Madrid, and aid in these areas would be particularly useful and appreciated.

The United States must, of course, understand that in times of crisis the best and the worst of a country emerges. Mexico's posi-

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tion on foreign aid after the quake unavoidably reflected the ambiguous and contradictory feelings toward the rest of the world and the U.S. in general. Whatever true or perceived mistakes many Mexicans detected in our Government's dealing with this critical issue, this hour of emergency is perhaps not the most propitious time for expecting a change in secular thinking. What is true for Mexicans is all the more true for the United States. We expect our friends to bear with us because that is what we ourselves are doing. Many Mexicans feel the earthquake of September 19 will be a watershed in the country's history. True, hyperbole and natural disasters tend to go together, and this may be the case today. Nonetheless, there are sufficient grounds for believing that the country that will emerge from under the rubble of Mexico City will be substantially different from the one most Americans and all Mexicans know. If Mexico can find a lasting solution to the debt problem, if it can promptly and effectively transform its political ways, satisfying the people's desire for a deep democratization of the nation's society and institutions, if finally it receives help from abroad with generosity and sensitivity, with interest and concern but also with responsibility and tact, then the earthquake will prove to be a watershed, costly but fruitful. If not, then we are all in very, very serious trouble.

Thank you very much.

[Mr. Castaneda's prepared statement follows:]

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PREPARED STATEMENT OF DR. JORGE G. CASTANEDA, SENIOR ASSOCIATE, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

DON'T CORNER MEXICO!

by Jorge G. Castañeda

The breakdown of the Contadora peace initiative because of either infinite procedural nitpicking or substantive confrontation marks, among other things, the end of Mexico's first starring role on the international political stage. The adventure had begun in the late 1970s, at a time of U.S. interest in and sympathy for Latin America, new oil discoveries, and high oil prices, and culminated in the joint Mexican-Colombian-Panamanian-Venezuelan effort to bring peace to Central America. But it has been crippled by the weight of foreign debt, by domestic disenchantment, and by President Ronald Reagan's Central American machismo. Although it may not be evident today, the demise of Mexico's foreign policy may prove to be one of the most serious casualties of Reagan's Central America policy.

Present appearances not withstanding, Mexico was not always interested in Central American and Caribbean Basin matters. It dabbled in the region's politics in the 1920s, when then President Plutarco Elías Calles sent arms to the liberals in Nicaragua; in the 1930s, when Augusto César Sandino, the self-styled Nicaraguan liberator, tried to raise funds and sought refuge in Mexico; and in the 1950s, when Fidel Castro, Ernesto ("Che") Guevara, and their guerrillas launched the Cuban revolution from the Mexican resport of Tuxpan. In general, however, Mexico had looked north or across the Atlantic Ocean when it focused on the rest of the world. So it was with some surprise that the country's inhabitants—and foreign observers—realized in the late 1970s that Mexico was seeking a leading role in the unfolding Central American crisis.

As Mexico became increasingly active in the

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area's affairs, many analyses of the reasons for and origins of this activity appeared. These analyses cited Mexico's historical sympathy for revolutionary movements in Latin America, deeply rooted in the country's own revolution of 1910; its ideological posturing for the benefit of the domestic political system's left wing; and the simplistic—and nearsighted—U.S.-baiting by a Mexican president, José López Portillo, who let his dislike for former President Jimmy Carter get out of hand. More accurately, it was seen as an attempt by Mexico to turn its northern neighbor's growing difficulties in Nicaragua, and later, El Salvador, to its own advantage at a time of strained Mexican-U.S. relations. These and other analyses of Mexico's new activist foreign policy came and went across the Rio Grande, all had some ring of truth to them, but none could fully explain Mexico's intentions in the Caribbean Basin.

The demise of Mexico's foreign policy may prove to be one of the most serious casualties of Reagan's Central America policy.

In fact, though never clearly expressed and only vaguely perceived in different sectors of society and government, from mid-1978 on, Mexico's actions sprang from a general idea of goals in the region and how to achieve them. Mexican policy aimed to carve out a sphere of influence in the only areas where such an ambition was feasible: Central America and the Caribbean Basin. South America was too divided and removed from Mexican concerns and capabilities, and no other region then had anything remotely like a strong link to Mexico or seemed close to developing any in the future. True, the country had never shown much interest in the "sister republics" to the south or in the island countries to the east, but nonetheless these countries had always looked to Mexico with a mixture of fascination and fear, respect and resentment.

Indeed, Central American elites had been studying law, medicine, engineering, and the art of war in Mexico for many years. The area's revolutionaries and reformers, from Cuba's José Martí at the turn of the century to CIA-ousted Guatemalan President Jacobo Arbenz Guzmán in 1954, had always conspired from, fled to, and come to die in Mexico. So in addition to the country's obvious affinities with most Caribbean Basin countries—shared language, history, and problems—Mexico had sound cultural grounds for envisaging a durable influence in the region.

Some solid, if less obvious, economic and political reasons for thinking in these terms also existed. By the end of the 1970s, Mexico had become a relatively developed country, by Latin American standards. Despite serious structural weaknesses in its economy, glaring inequities in the distribution of wealth, and recurring economic crises that shook the country's finances and self-confidence, Mexico had built a large and diverse industrial base. Its economy increasingly complemented that of most Central American and Caribbean countries. And the discovery in 1976–1979 of new, giant oil reserves in the states of Chiapas and Tabasco and in the Campeche Sound, as well as the prospect of high revenues from oil exports, made Mexico's economic future seem bright, even dazzling.

In contrast, the isthmus and island economies have remained essentially agricultural exporters of commodities. They depend mainly on American imports for consumer goods and for most of the tractors, herbicides, pesticides, and fertilizer they need to produce the cotton, coffee, bananas, sugar, and meat they sell on the world market. Mexico produced nearly all of the same goods imported—largely from elsewhere—by the Caribbean Basin economies. On paper, it looked like an ideal marriage.

But hypothetical economic considerations alone could not make Central America and the Caribbean Basin the keystone of Mexican foreign policy. Mexico would never be able to wage, much less win, an economic competition with the United States, the region's reigning power since the turn of the century. How could the inefficient and poverty-ridden

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Mexican economy compete with the United States, literally in America's own back yard?

Courting the Left

The answer, of course, was to compete not economically, but politically. Here the emerging social unrest and desire for change in much of the region entered into the equation. Mexico would be able to nudge out the United States as the dominant influence in the Caribbean Basin only by winning the political sympathies of the area's inhabitants and governments. And it would find this sympathy only on the left, not on the right end of the political spectrum. Subsequent American warnings notwithstanding, Mexico felt it had nothing to fear from left-wing governments in the Caribbean Basin. It knew that, despite their Marxist-Leninist trappings, Latin American revolutionaries continued to be middle-class nationalists with a popular following. It had learned from the records of Guatemala from 1950 to 1954, Cuba since 1959, and Chile from 1970 to 1973 that left-wing governments would never think of meddling in Mexican politics: Mexico was their best—their only—ally in the Western Hemisphere.

Although most of the countries in the area had right-wing, pro-American, and unpopular leaders who would never look to Mexico as a counterweight to the United States, the situation was changing rapidly. The victory of the Nicaraguan revolution seemed imminent. That and the apparently favorable prospects for insurgencies in El Salvador and Guatemala in late 1978 and early 1979 gave Mexico every reason to be optimistic. If the Sandinistas overthrew Anastasio Somoza Debayle; if the guerrillas in El Salvador rode on the Sandinistas' coattails to victory in their own country; if the Guatemalan revolutionaries were in turn swept into power by the regional revolutionary tide; if geographic realities obliged Honduras and Costa Rica to align themselves with their neighbors' policies; and if Mexico were seen by these newly triumphant revolutionary movements as a true and trusted ally, it would achieve the anti-American political edge it sought. For no matter how moderate the Central American and Caribbean revolutionaries might appear in dealing with the United States, their anti-American nationalism was deep enough for Mexico to turn to its advantage.

Mexico had its work cut out for it: Support the Central American revolutionaries in their quest for power; transform, with time, the political capital thus acquired into lasting influence; and ensure the staying power required by a long-term policy. By wagering that the future of Central America and the Caribbean belonged to a nationalist, not fully democratic, and largely anti-American Left, Mexico may have been betting on the right horse—but only in a very long race.

It also was assuming an additional task, possibly the most difficult: conciliating the interests of these new regimes with U.S. interests. Little would remain of Mexico's regional ambitions if some form of coexistence were not worked out between the United States and the revolutionaries in Central America and the Caribbean. Mexico had both a motive and the capability to encourage a modus vivendi. But it could succeed only with some very deft diplomatic maneuvers: supporting the rebels in their struggles against U.S.-backed regimes until they took power, then turning around and convincing the former adversaries that they had to live with each other—a formidable, perhaps unrealistic, task.

Nevertheless, some factors were operating in Mexico's favor. To begin with, its policy was based exclusively on self-interest. Mexico supported the tide of radical change in Central America and the Caribbean not out of sympathy—though sympathy clearly existed—or anti-American spite—a small dose of which is always present in Mexican foreign policy—but rather because becoming a regional power required a left-leaning Caribbean Basin. Such a policy always would be easier to sustain domestically than one based on high-minded but abstract principles that would entail some sacrifice of Mexico's interests. Further, Mexico could switch back and forth between supporting revolution and reconciling the Left with U.S. interests, depending on Mexican, regional, and American political considerations.

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Third, and most important, this approach did not appear to oppose the core of the Carter administration's approach toward both Latin America and the developing world as a whole. Under Carter, the United States seemed to be indicating that it could live with radical governments in the Third World if they did not alter fundamental geopolitical equations or massively violate human rights. Mexico was confident that it would have enough leverage with Central American and Caribbean radicals to ensure their respect for these American constraints.

Between late 1978 and early 1982, then, Mexico openly supported revolution in Nicaragua; viewed with favor its progress in El Salvador and Grenada; improved and emphasized its ties with Cuba; and watched with interest (and some unease) as guerrilla warfare heated up in neighboring Guatemala. Starting in late 1978, Mexican Interior Minister Jesús Reyes Heroles and Carlos Sanabres Pérez and Gustavo Carvajal Moreno, then chairman and secretary general, respectively, of the ruling Institutional Revolutionary Party (PRI), appropriated small but significant amounts of money for the Sandinista guerrillas and their political front, the Group of Twelve. The Mexican embassy in Managua became a center for anti-Somoza conspiracies, a haven and clinic for tired or wounded guerrillas, and a meeting place for opposition leaders. Nicaraguan Vice President Sergio Ramírez Mercado, Foreign Minister Miguel d'Escoto Brockman, Attorney General Ernesto Castillo Martínez, and other current Sandinista officials all made the embassy their home for varying periods of time.

But Mexico's most important role in the Nicaraguan insurrection came in May and June 1979, when international pressure, primarily from Latin American countries, as much as internal armed conflict, forced Somoza from power. In May, shortly after visits to Mexico by Castro and Costa Rican President Rodrigo Carazo Odio, López Portillo broke diplomatic relations with Nicaragua and encouraged other Latin American countries to do the same. At a June meeting of the Organization of American States, the Mexican foreign minister openly defended "the sacred right [of the Nicaraguan people] to rebel against tyranny" and played a key role in stopping the United States from dispatching an inter-American peace keeping force intended to impede Sandinista access to power—even if it was too late to save Somoza. López Portillo shipped substantial quantities of ammunition to the Sandinista southern front, and on July 19 the Mexican presidential airplane carried the newly formed junta into Nicaragua—and power—from Costa Rica.

Through 1983, Mexican economic aid to Nicaragua topped $500 million, including outright grants, loans, and free or discounted oil. López Portillo visited Nicaragua three times, and Sandinista comandantes called regularly at the Mexican Presidential Palace and the Foreign Ministry, often with a lengthy shopping list. Although Mexico was criticized then, as now, for not attaching at least some strings to this support, it viewed the policy as an attempt to buy political trust for the future.

Inevitably, Mexico began looking at the situation in El Salvador through the lens of the Sandinista victory. If developments there proceeded as they had in Nicaragua in 1979, there was no reason to believe a similar pattern would not take hold. In early 1980, Carvajal, by then chairman of the PRI, met with the Salvadoran rebel commanders and their political representatives; in August 1980, the Mexican Foreign Ministry established high-level and ongoing communications with the Farabundo Martí National Liberation Front (FMLN), a federation of guerrilla groups, and its political arm, the Democratic Revolutionary Front (FDR). This relationship with the Salvadoran rebels allowed Mexican authorities to monitor closely events in El Salvador; it also created, even more than in Nicaragua, the kind of trust that would serve Mexico greatly later, if the Salvadoran insurgents attained power.

The best example of this long-term political investment was the so-called Franco-Mexican declaration on El Salvador. In August 1981, the newly elected government of French President François Mitterrand joined Mexico in calling for a negotiated settlement in El Salva-

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der and recognized the FMLN and the FDR as "representative political forces." Coming during a period of military weakness for the guerrillas, this diplomatic move gave the rebels the single most important expression of international support they have ever received.

Mexico also strengthened its ties with Cuba. In August 1980, López Portillo traveled to Havana, where he was given a hero's welcome. Castro, in turn, twice visited the Mexican resort of Cozumel. In late 1981, when Cuba desperately needed dollars to meet payments on its debt to Western banks, the Mexican government secretly lent the Cubans $100 million. And, though Mexico gave no aid to Grenada, the late Prime Minister Maurice Bishop was warmly received in Mexico City in late 1981.

Mexico's armed forces never viewed Guatemala as they viewed the rest of the region and clearly would have opposed any open or significant support of revolution south of the border. Yet López Portillo's policy toward the Guatemalan insurgency was not totally at odds with Mexican policy toward Central America as a whole. In mid-1981, when the first Guatemalan refugees began pouring over Mexico's southern border, López Portillo, after some initial hesitation, ordered a reluctant army to accept their presence. This decision in part reciprocated advance warnings from the guerrilla leaders that refugees soon would start leaving Guatemala in search of a Mexican haven.

If Mexico clearly emphasized the prorevolution track of its dual Central America policy, it did not totally discard efforts to find a modus vivendi between Washington and the Central American Left. Mexico repeatedly lectured the United States on the need to coexist with Nicaragua, normalize relations with Cuba, and negotiate a solution to the civil war in El Salvador. Mexico also tried to convince the Sandinistas, the Cubans, and the Salvadoran insurgents to take American concerns into account. Although official and unofficial meetings and exchanges of views among the various parties did take place, these efforts remained fruitless. Despite certain signs of leftist flexibility, such as a Sandinista willingness to discuss the departure of Cubans from Nicaragua without defining their status as teachers or advisers, Mexico proved unable to deliver American concessions and consequently was unable to transform flashes of apparent moderation from Cuba, Nicaragua, and the Salvadoran rebels into meaningful concessions.

Mexican policy aimed to carve out a sphere of influence in the only areas where such an ambition was feasible: Central America and the Caribbean Basin.

In November 1981, then Secretary of State Alexander Haig, Jr., met with Cuban Vice President Carlos Rafael Rodríguez in Mexico City; 4 months later, special presidential envoy General Vernon Walters traveled to Havana for a 7-hour talk with Castro. According to Mexican officials, in early 1981, just after Reagan's first inauguration, then national security adviser Richard Allen and Director of Central Intelligence William Casey agreed to a Mexican request to hold talks secretly, in Washington, with Salvadoran rebel leaders.

But Haig vetoed the arrangement as soon as he learned of it, considering the idea entirely contrary to his Central America policy. Other Mexican attempts to promote talks between the warring factions in El Salvador fared no better because of U.S. opposition and a simple fact of diplomatic life: Mexico was too supportive of the Central American and Caribbean Left to play the role of honest broker, yet if it turned away from its new-found allies, it would lose their trust—its only card to begin with.

Mexican efforts on Nicaragua likewise failed repeatedly, with the first phase of Mexico's Central America policy culminating in February 1982, when López Portillo visited Managua, Nicaragua, publicly called for talks and mutual concessions, and tried to convince the United States to enter into formal negotiations with the Sandinistas. But once again Haig blocked the initiative, although some

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progress was made in identifying both sides' grievances and aspirations.

By this time, however, economic insolvency had hit Mexico. López Portillo had become a lame duck, and increasing domestic opposition to Mexico's open support of "subversives" had rendered this policy inoperative. The end of the first phase and the beginning of the second might have come in early 1982, when a European democracy privately asked López Portillo to join it in financially supporting the FMLN-FDR. Mexico refused, though this meant that European funds would not be forthcoming either. Likewise, in December 1981, after France announced a sale of $17 million in arms to Nicaragua, Mitterrand asked Mexico to support publicly this act. Mexico turned him down.

A New Mexican Stance

During the transition between the outgoing administration of López Portillo and the new government of Miguel de la Madrid Hurtado, Mexico shifted the emphasis of its policy from supporting revolution in Central America to mediating between that revolution and its avowed adversary, Ronald Reagan. And in order to mediate with any chance of success, Mexico had to slide over to the diplomatic Center, a difficult place in Latin American politics under any circumstances, and particularly during the Reagan era.

In September 1982, Mexico and Venezuela sent jointly signed letters to the presidents of Nicaragua, Honduras, and the United States, calling on them to negotiate their differences. For the first time, Mexico publicly stated that Nicaragua was not entirely blameless in the regional crisis, especially concerning tensions with Honduras. The initiative, however, was still essentially pro-Sandinista. Four months later, after de la Madrid's inauguration, this joint Mexican-Venezuelan effort was transformed into the Contadora initiative, named after the Panamanian resort island where the foreign ministers of Colombia, Mexico, Panama, and Venezuela met in early 1983.

The Contadora process revealed not only a major revision in Mexican positions, but also an underlying continuity, however unaware of it Mexican policymakers may have been at the time. As Mexico's own economic problems increased; as the Guatemalan insurgency suffered a nearly fatal blow at the hands of later ousted president General Efraín Ríos Montt; as the Salvadoran guerrillas proved unable to defeat the U.S.-backed government; and, perhaps most important, as the very survival of the Nicaraguan revolution came into question because of the Sandinistas' own mistakes and Reagan's support for the *contras*, Mexico began to emphasize its "mediation" function as opposed to its "support" role. The Contadora group adopted a more centrist approach than previous Mexican initiatives not only because of the presence of other countries more sympathetic to U.S. positions, but also because of the new "balanced and objective" stance laid out by de la Madrid.

This new Mexican stance was reflected in many of the Contadora group's documents and arguments. Nicaragua's problems with Honduras were made the center of the regional crisis, whereas before Mexico had stressed the need to address both the Nicaraguan and the Salvadoran dimensions of Central American tensions. The insurgents in El Salvador clearly perceived this shift. "Contadora, as a group, however, has been unwilling up to now to use its good offices to work for this dialogue [between the FMLN-FDR and Salvadoran President José Napoleón Duarte]. It has not even directly discussed the Salvadoran case," stated an official FMLN-FDR document of mid-1984.

A series of symmetries also was established. Each of these symmetries ran counter to Mexico's previous positions, but each made Mexico a more credible mediator. Cuba was placed alongside the United States in the category of interested outside parties. When the four Contadora presidents met in Cancún, Mexico, in July 1983, they sent messages to both Castro and Reagan, asking for their support. In a January 8, 1984, bulletin issued after a meeting of the Contadora foreign ministers, the insurgents in El Salvador were equated, at least implicitly, with the Nicaraguan *contras*. Both were referred to as "irregu-

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lar forces which aim to destabilize the Central American governments."

The questions of internal reforms, democratic elections, and respect for human rights were addressed in individual sections of the Contadora group's documents, and particularly in the Revised Contadora Act for Peace and Cooperation in Central America. This put Nicaragua's "self-determination" on an equal footing with El Salvador's "human rights violations," which Mexico had repeatedly condemned at the United Nations General Assembly. Neither issue, the act implied, could be considered merely an internal matter. Other, less important changes in the Mexican position also were reflected in the Contadora documents.

While pursuing the multilateral, symmetrical approach to peace in the region through the Contadora process, Mexico also insisted, but with greater authority and success than before, on the need for direct U.S.-Nicaraguan talks. By May 1984, when de la Madrid visited Washington, Mexico's new attempt at playing the honest broker apparently began to pay off. Reagan soon accepted the principle of direct dialogue with Nicaragua, and 2 weeks later, Secretary of State George Shultz made a brief stop at the Managua airport for the first of nine high-level exchanges between the two countries. Almost all the other meetings were held in the Mexican resort of Manzanillo, a tribute to Mexico's role in bringing about the talks.

In addition to altering its views on many Central American issues in order to make Contadora credible, Mexico has toned down its other forms of support for Central American revolutionaries. Economic aid to Nicaragua was cut back sharply and oil shipments were subjected to a number of financial conditions, leading Nicaragua to turn to the Soviet Union for what quickly became the bulk of its petroleum supplies. Sandinista leaders travel to Mexico less frequently and more discreetly than before. Two and a half years into his 6-year term of office, de la Madrid has yet to visit Nicaragua or Cuba. Moreover, several Cuban diplomats have been either expelled from Mexico or quietly asked to leave.

Salvadoran insurgent leaders continue to hold press conferences and meet with foreign delegations in Mexico City, but they no longer enjoy their previous access to senior Mexican officials. Nor do they remain Mexico's main Salvadoran contacts: Foreign Minister Bernardo Sepúlveda Amor's attendance at Duarte's 1984 presidential inauguration was widely interpreted as a sign of rapprochement between the two governments. Finally, although refugees from Guatemala continue to enter Mexico, most of them have been more or less forcibly transferred to areas removed from the border, largely in response to pressure from the Guatemalan army.

But just as Mexico did not completely forgo mediation when it most ardently supported revolution, it has not entirely forsaken its revolutionary friends while pursuing conciliation. It continues to maintain closer and more trustful relations with Nicaragua than with any other Central American country; it improved its ties with Duarte but has not given them a higher standing than those it maintains with the FMLN-FDR. In spite of the distance it has put between itself and Cuba, communication, official travel, and consultations continue, in a way unique in all of Latin America.

A Regional Force for Change

Yet despite sporadic achievements, Mexico's first incursion into the tricky waters of international affairs has not met with resounding success. For if in 1982 Mexico had the option to shift from supporting revolution to mediating, in 1985 there are no such options left.

The failure of the Contadora effort, because of U.S. unwillingness to exchange an effective, albeit aggressive, probably illegal, and certainly unpopular (in Latin America) policy toward Central America for a well-intentioned, theoretically verifiable, but probably unenforceable document, is the main sign of Mexico's frustrated ambitions in Central America. Mexico cannot go back to aiding or sponsoring anti-American rebellions. An increasingly vocal and powerful conservative opposition probably would take to the streets, the United States doubtless would consider such action unfriendly, and the ensuing confrontation

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undoubtedly would be more than de la Madrid could bear after nearly 3 years of highly unpopular economic austerity.

But with no tangible results to show for its Contadora efforts, Mexico cannot continue pursuing the elusive, if not impossible, goal of "peace with honor for all in Central America." As might be expected, it has lost leverage with its former revolutionary allies, though they continue to view Mexico as a friend. Moreover, Mexican domestic support for any Central American involvement is rapidly eroding, partly because of growing disenchantment with everything the government does, and partly because of the conservative and isolationist drift that has been accelerated by economic ills. Yet a humiliating return to introspective isolationism also would endanger the political system's legitimacy. Mexico has literally no place left to go in Central America, yet has nowhere to go in international affairs other than Central America.

Washington obviously cannot entirely subordinate its Central America policy to Mexico's problems. Indeed, some might argue that, thanks to its well-deserved failure, Mexico finally can begin to act responsibly in the region. This view, probably as widely held in Mexican business and conservative circles as it is in Washington, may win debating points, but it reveals a basic misunderstanding of Mexican politics. True, Mexico strove to create a sphere of influence for itself in the Caribbean Basin partly out of delusions of grandeur, partly out of national ambition, and partly to have more leverage in its everyday, often prickly relationship with the United States. But traditional Mexican foreign posturing, if not a foreign policy in the strict sense of the word, has always played a key role in the delicate system of checks and balances upon which Mexican political legitimacy rests.

This key role has made foreign affairs the one realm of government action where the gap between the rhetoric of the revolution and actual policy is not outrageously wide. The Mexican political system might be able to function effectively without the progressive international stance that until now has neutralized its institutional left wing. Moreover, Mexico's support for left-wing causes abroad has rarely been intended to placate the country's own extreme Left, which has always been dealt with through repression and corruption. The actual domestic purpose of Mexican foreign policy traditionally has been to silence or paralyze sectors of the Mexican establishment that at different times may have considered opposing the government from a leftist perspective because of its various domestic policies.

Such opposition was deemed illegitimate to the extent that it weakened the government's support for Republican Spain in the 1930s, the Allies during World War II, Castro's Cuba in the 1950s and 1960s, Salvador Allende's Chile in the 1970s, and the Nicaraguan and Salvadoran revolutionaries in the 1970s and 1980s. At the same time, official support for worthy causes abroad allowed many intellectuals and politicians in the Mexican establishment to continue supporting the government in other fields without losing face with their leftist colleagues. The current stability of Mexican politics—however tenuous—indicates at the least that foreign policy may be one contributing factor. And current U.S. policy in Central America has helped take this tool almost completely out of Mexican leaders' hands.

Because of the ever-present tensions in bilateral U.S.-Mexican affairs, Mexico cannot afford to follow U.S. policy in Central America to the letter, even if domestic support for such a course among the urban, U.S.-oriented middle classes is growing. In order for Mexico to make important concessions that Washington is currently pressing for on bilateral issues—most recently, the drug trade—it must be able to prove its independence in other ways. But if Mexico cannot support the United States or continue its Central America policy in any mode, then it has no foreign policy left at all. And if it has no foreign policy, Mexican politics must function without one of its most prominent features. This feature may be redundant. Yet it may also be indispensable to the system's ability to reproduce and maintain itself. No one knows, but the risk of finding out, at a time of deepening economic crisis, seems excessive.

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The United States should not humiliate Mexico and Central America, nor should it foreclose Mexican policy in the region. The Contadora process may not be a realistic way out of the Central American quagmire, and Mexico may not yet be the regional power that can conciliate the region's desire and need for change with key U.S. national security interests. But until now, whatever certain conservatives in the United States may think, Mexico has been part of the solution in Central America, not part of the problem.

In time, a Mexican government with sufficient domestic clout once again may be able to play an active role in the Caribbean Basin. If this activism coincides with greater realism on the part of the region's revolutionaries and, above all, with a much more pragmatic and more realistic definition of U.S. national security interests in Central America and the Caribbean, Mexico may yet achieve its ambitious goals. Its recent record will serve it well in negotiations and revolutions to come. Eventually, the United States will have to define its regional stake in terms that do not change with every administration, with every secretary of state, with every national security adviser. Only then will Mexico be able effectively to foster needed change, overall stability, and geopolitical realism. Only views that are clearly spelled out, serious, and constant can be conciliated.

If Washington insists on underlining Mexico's present regional impotence; if it continues systematically to disqualify, reject, or wear down every Mexican attempt to further its current goals in Central America; if it leaves Mexico no choice but to withdraw from all international activity and simply to manage its day-to-day affairs with the United States, then Mexican instability may become a real danger no matter what happens in Central America. This instability is much less likely to take the form of a left-wing drift or takeover than of the slow breakdown of the finely tuned, delicately crafted, clockwork-like mechanisms that have guaranteed Mexico's political stability since the 1930s. A line in the sand, whether drawn by Ronald Reagan or by anyone else, cannot possibly be worth it.

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Mr. MACKAY [presiding]. We will now hear from Dr. Dickie.

STATEMENT OF PAUL M. DICKIE, PROFESSOR OF INTERNATIONAL FINANCE, THE AMERICAN GRADUATE SCHOOL OF INTERNATIONAL MANAGEMENT

Mr. DICKIE. Thank you, Mr. Chairman.

It is a pleasure to be here today, and I think, Mr. Chairman, having heard many of my views expressed by other people at this table, I can be very brief.

To start, I would like to give you a little bit more of an appreciation of the Mexican debt crisis. In that area I would like to say initially that Governor Babbitt misspoke when he talked about repaying the debt. As Congressman McCain indicated we will be very successful if Mexico can just maintain a minimal servicing of that debt; that is, interest only, no principal repayments.

Then I would like to, following the outline of the debt crisis, give you some views on the ramification of that crisis on United States-Mexican relations in terms of investment, trade and border issues. Finally, I will give you a couple of thoughts on the solution relative to Secretary Baker's proposal in Seoul.

HISTORICAL LOOK AT THE MEXICAN DEBT CRISIS

First is the nature of the debt crisis. The crisis began in August 1982. It, in turn, was the result of a combination of the oil finds in the mid-1970's and the subsequent government overspending and the excessive borrowing to finance those expenditures. The International Monetary Fund saw it in that light. The restructuring program that they designed for Mexico had, as its main focus, a reduction of the public sector deficit from 18 percent of Gross Domestic Product in 1982 to 8.5 percent in 1983, 5.5 percent in 1984, and 3.5 percent in this current year.

Mexico performed admirably and beyond all expectations in 1983. Imports fell fully one-third from the $24 billion in 1981 to only $8 billion in 1983. It was remarkable that a decrease of that magnitude could take place. Gross Domestic Product also fell a full 6 percent in that year. In 1984 Mexican economic policies were relaxed somewhat. The public sector deficit agreed target in 1984 was 5.5. percent of GDP; Mexico got down to only 7.4 percent of GDP. Still good, but not as good as hoped. Inflation, instead of 40 percent, was 60 percent, and the peso rate of devaluation at 13 centavos a day was only keeping the rate competitive with an inflation rate of 30 percent and the inflation rate, as I mentioned, was 60 percent. So, we had some erosion of the economic restructuring program in 1984.

Mexico had elections in mid-1985 and pork barrel politics, I believe, took precedence. We had a situation where, in order to achieve some popular support, government expenditures had to rise, and some real growth resulted.

To put Mexico's debt service numbers in context, Mexico had debt service in terms of interest only of about $10 billion in 1983 and 1984. During each year they had new money totalling $5 billion from the International Monetary Fund and the international commercial banks. That meant that Mexico's net debt service was

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reduced to $5 billion in each of those 2 years. During those 2 years Mexico built reserves and had a rather successful restructuring on a net $5 billion, debt service burden.

Now, accompanying that restructuring and the sucessful servicing of the debt in those 2 years was one of the most severe recessions that I think we have seen in debt restructuring exercises. If you look at the fall in per capita income in peso terms, it is probably only averaged 10 percent; but if you look at it in dollar terms, which is how you feel it in Mexico, it is somewhere above 30 percent, probably closer to 40 percent. It was a very major decline in real income in Mexico.

The impacts in terms of other areas of our relationship with Mexico have also been severe. We have in Mexico direct investment of $5.4 billion and we are not, obviously, getting the expected levels of profits from those investments; and Mexico has been hesitant in welcoming new investments from this country. I would doubt very much if the flow of investments picks up in the near term future.

We also have bank debts in Mexico of $34 billion, and our major banks have over 50 percent of their equity in loans to Mexico. As Congressman McCain indicated, the regional banks in the Southwest are in an equally difficult position on those debts.

UNITED STATES-MEXICAN TRADE RELATIONSHIP

Our trade with Mexico is substantial. In 1981 we exported about $18 billion to Mexico. Those exports have declined, because of Mexico's difficulties, to about $12 billion. Meanwhile our imports from Mexico have steadily increased, so that our trade surplus of $4 billion in 1981 has turned into a deficit of about $6 billion in 1984.

We should also remember that there are some strategic items involved in our bilateral trade. Fifty percent of Mexico's oil petroleum exports are to this country and that amounts to about a sixth of our supplies of petroleum in this country. So it is an important security issue.

Tourism, as has already been mentioned, is in a declining trend because of occurances of violence in Mexico. The violence along the border involving tourists in car thefts and petty robbery has grown in recent years and I think a large part of it is a byproduct of unemployment and the economic austerity programs that were put in place. The recent earthquake added to the negative trend.

The in-bond assembly plants along the Mexican border, the so-called maquilas are the one bright spot in our bilateral trade and investment relationship with Mexico. This is because of the sharp devaluation of the peso and the fact that you can get $4 per day labor in the border areas of Mexico. As a result the maquilas are most likely going to contribute up to $2 billion to Mexico's balance of payments this year, probably the only positive area in our relationship with Mexico.

SECRETARY BAKER'S PRESCRIPTION IS ABSOLUTELY RIGHT

Now, looking at some of the solutions and Secretary Baker's proposal in particular, I think he is absolutely right about the policy

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prescription that he proposes. In addition to anti-inflationary fiscal and monetary policies, he proposes that debtor countries such as Mexico should restructure their economies to increase reliance on open markets and reduce state intervention. Mexico is strangled by rules and regulations. And I suppose that the International Monetary Fund in part is at fault. When I see a program with the Fund, where you end up with about five exchange rates, then that program has been less than fully effective. You cannot have 5 peso prices prevailing for the dollar at the same time as it only leads to graft, corruption and uncertainty in a key area of the economy. That same kind of structure accompanied by excessive rules and regulations prevails throughout the economy, and it needs to be freed up. The Mexican Government also needs to get rid of some of those loss ridden public sector enterprises and turn them over to the private sector.

So I think the policy prescription is absolutely right. On the incentive side seeking to persuade the debtor countries to participate I have to say I think the Secretary's proposal is wrong; it is wrong in both form and the substance.

During the 2 successful years of the restructuring period Mexico added about $10 billion in debt to reduce the servicing costs of their debt during those 2 years. All that the new loans achieved was time while on the negative sides an additional annual interest charge of up to $1 billion was increased. Mexico's debt-to-export ratio has risen over that period of time where we would have hope that it would decline. The problem seems to be in nonpetroleum exports, that have stagnated at about $7.5 billion. They have not expanded as expected. Here we get back to the fact that Mexico needs to have a freeing up of the rules and regulations. You cannot cut imports as much as Mexico did just through the price mechanism. It was done in part by peso devaluations but more importantly it was achieved through restrictive and preferential import licensing. As soon as you do that, you strangle your economy and it cannot be productive.

So on the substance of it, the problem is that the Secretary's proposal envisages more loans to Mexico. More loans simply to help pay the interest charges leads nowhere. In fact, it leads to a worsening of the situation over time where Mexico accepts a bigger debt, and more interest charges which, in turn, they are not able to service.

So I feel that something direct must be done in terms of reducing the interest burden on the Mexican economy, and I have made a suggestion along those lines in my written submission. But it does not have to be that one. There is any number of different ways that it could be done, and that is only one suggestion.

If we were, as a second best, to accept the new money route proposed by the Secretary, it would at least hold us over for a while. However, I think the banks will not go along with it unless there are guarantees from the World Bank or implicit guarantees from the U.S. Government to induce the commercial banks to put new money into Mexico. If there are explicit guarantees from the World Bank, we as the United States stand four square behind those guarantees, and since Mexico will be unable to repay it becomes in

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essence a back door way to provide the required aid to Mexico. I think, the form of this approval is wrong.

Thank you, Mr. Chairman.

[Mr. Dickie's prepared statement follows:]

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Prepared Statement of Paul M. Dickie, Professor of International Finance, the American Graduate School of International Management

Mexico's economic and political stability are of the utmost importance to the United States. The internal political stability of Mexico together with its restrained approach to the solution of mutual problems has been invaluable. At question now is how much of our economic resources the U.S. is willing to commit in order to ensure a continuation of this constructive relationship. It would appear that since the onset of the Mexican debt crisis in August 1982 that the Administration has been reacting to the pending crises in an ad hoc and hesitant manner.

Mexico's current economic problems are rooted in its government's overspending and other inappropriate economic policies of the late 1970s. The substantial oil discoveries of the mid 1970s had the potential to accelerate economic development but in reality have resulted in large-scale misallocation of resources and the world's second largest debt burden. Mexico's current debt of $96 billion requires that three-quarters of current oil revenues must be utilized just to meet the interest payments. Since 1982 per capita income has fallen in peso terms by a relatively modest 10% but in more realistic dollar terms, the decline has been a devastating 32 %. In 1984 Mexico reflated its economy with the consequence that earlier this year Mexico failed to

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meet its target under the International Monetary Fund (the Fund) three year restructuring program. In order to get back into compliance with this program Mexico will need to reimpose austerity. This approach would result in high unemployment and continued stagnation of the economy and this is the perceived manner by which Mexico is supposed to service its rescheduled debt. The cost of this approach to Mexico and to the United States would be too high and would almost certainly end in failure.

The first part of this paper is to briefly outline the nature of the Mexican economy and its interelationship with the United States. Next, the nature of the Mexican debt crisis and its consequence for political stability, immigration policies, U.S. banking and the border areas will then be reviewed. Finally, proposed solutions will be explored. In particular the Secretary of the Treasury's proposals at the joint Fund and World Bank Annual Meetings in Seoul to redress the debt crisis will be examined.

Background:

Mexico is a country of 77 million and has a per capita Gross Domestic Product (GDP) equivalent to $2,300, about one-seventh of that in the United States. The political and economic focus of the country is Mexico City, the largest urban center in the world with over 16 million inhabitants. The recent earthquake has intensified the problems of strained public services and the external debt crisis. Exacerbating the other problems of Mexico has been a

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combination of urban migration and a high population growth rate, the latter estimated at 2.5%. The population is young and an economic growth rate in excess of 3% is required to keep pace with the need for new employment opportunities. Trends in GDP are shown in Table 1.

The United States has vested interests in Mexico well beyond the 1760 mile common border. U.S. direct investment in Mexico now has a book value of $5.4 billion, mainly in the manufacturing area. Even more important, U.S. banks have outstanding loans to Mexico amounting to $33.9 billion (March 1985), most of which is to the public sector. Trade is also substantial. Exports to Mexico peaked at $18.2 billion in 1981 and amounted to $12.0 billion in 1984. Imports from Mexico, mainly petroleum, are large and growing and in 1984 totalled $18.0 billion. From a trade surplus of $4.4 billion in 1981, the U.S. currently is running a trade deficit of $6 billion with Mexico.

Table 1: Developments in Real Gross Domestic Product (GDP) (in percent changes based on GDP data in constant 1980 prices)

	GDP	Per Capita GDP
1979	9.16	5.94
1980	8.32	5.31
1981	7.95	5.16
1982	-0.01	-2.57
1983	-5.82	-8.44
1984	3.47	1.07

Source: International Financial Statistics

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U.S. business operations depend heavily on low cost yet skilled Mexican labor. Access to this labor force is achieved through foreign investment in Mexico, particularly along the border in the form of in-bond industries where parts are assembled in Mexico and are re-imported into the United States with only a tariff on the value added. In addition to legal immigration into the U.S. which provides mainly highly trained workers, agriculture and other labor intensive industries depend on a flow of illegal immigrants. Without those workers, some of these labor intensive industries in the U.S. might have to move their production facilities overseas.

U.S. border towns and cities are also heavily dependent on the level of income and growth in Mexico. During the early months of the debt crisis, retail sales in some of these border areas were off as much as 80% and have yet to fully recover.

The nature of the U.S.-Mexico relationship has varied and depended mainly on Mexican economic and political developments. Significant changes have occurred during the past decade.

With the discovery of major petroleum resources in the mid 1970s, Mexico embarked on a major development effort. As shown in Table 2, production volumes and revenues began to expand rapidly after 1978. In the following three years, the value of petroleum exports increased from $1.8 billion in

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1978 to $14.6 billion in 1981 while proven reserves almost doubled to 72 billion barrels.

Table 2: Mexican Crude Oil Output, Exports and Reserves (in thousand barrels per day and millions of U.S. dollars)

	Production	Exports		Reserves
	Volume	Volume	Value	Million Barrels
1978	1,212	365	1,848	40,194
1979	1,471	533	3,903	45,803
1980	1,941	828	9,768	60,126
1981	2,312	1,098	14,600	72,008
1982	2,746	1,490	12,500	72,008
1983	2,665	1,534	14,821	72,500
1984	2,760	1,526	15,000	72,500

Source: Banco National de Mexico and Pemex

The development effort in the late 1970s extended to all areas of the economy. New public services were extended and investment projects were undertaken to such an extent that government current expenditures tripled in the 1979-81 period while capital expenditures quadrupled. Despite the rapid rise in petroleum and other receipts, the public sector's deficit also rose six-fold in the three years ended 1981.

The excess demand pressures in the Mexican economy during the late 1970s were reflected in an acceleration of the domestic inflation rate from the 15% levels of the mid 1970s to 28% by 1981 (see Table 3). However, the major pressures on resources were reflected in the balance of payments as imports and external debt mushroomed.

Imports tripled to $24 billion in the 1979-81 period due to excess government expenditure and an exchange rate that had become overvalued. The growth of petroleum exports could not keep pace and the trade balance deteriorated as

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shown in Table 4. Interest payments and other service payments also rose sharply so that the current account deficit quadrupled to $14 billion in 1981. International bankers gave Mexico ready access to the debt markets and there were no difficulties in securing capital inflows and maintaining adequate international reserves.

Table 3: Developments in Prices
(period averages in percent)

	Consumer Prices	Wholesale Prices
1979	18.1	18.3
1980	26.4	24.5
1981	27.9	24.4
1982	59.0	56.1
1983	101.8	107.4
1984	65.5	70.4
Jan-Aug		
1984	38.5	39.3
1985	35.8	36.3

Source: International Financial Statistics and Mexico Update

Table 4: Balance of Payments
(in billions of U.S. dollars)

	1979	1980	1981	1982	1983	1984 (1)
Exports	9.3	16.1	19.9	22.1	22.2	24.8
Imports	12.1	18.9	24.0	14.4	7.7	10.8
Trade balance	-2.8	-2.8	-4.1	7.6	14.5	14.0
Interest payments	-3.7	-5.5	-8.4	-11.3	-9.8	-11.7
Other services and transfers	1.1	0.1	-1.4	-2.1	0.5	0.5
Current account balance	-5.4	-8.2	-13.9	-5.8	5.2	2.8
Net capital flows	5.8	9.2	15.0	2.3	-3.1	-0-
Change in reserves	0.4	1.0	1.1	-3.5	2.1	2.8

Source: Balance of Payments Statistics, Banco de Mexico and International Monetary Fund

(1) Partly Estimated

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The buildup in external debt was sharp during the 1979-81 period and, as shown in Table 5, the debt level more than doubled to $75 billion. The debt crisis was made inevitable in 1981 as oil prices dropped at mid-year and international banks became somewhat reluctant to extend further medium term loans. Mexico drew down their short term lines with the banks in the hope that oil prices would recover and permit them to replace these short term loans with medium term loans. Out of $14 billion borrowed from the international banks in 1981, $9 billion was due in one year or less. Since oil prices did not recover, Mexico found that a 1982 scheduled repayment of debt together with interest payments (total debt service) exceeded projected receipts from the export of goods and services by a wide margin. The debt crisis arrived early in 1982.

Table 5: Foreign Debt
(in billions of U.S. dollars)

1978	33.8
1979	40.4
1980	48.6
1981	75.3
1982	87.6
1983	93.8
1984	95.8

Source: Banco de Mexico, Secretaria de Hacienda y Credito Publico and the Economist Intelligence Unit

The Debt Crisis

The debt crisis was recognized in February 17, 1982 with the initial devaluation of the peso. The peso fell from

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27 to 47 to the dollar within 10 days. While the devaluation temporarily restored purchasing power parity for the peso, it was quickly offset by continued high government expenditures and a general wage increase in March. The devaluation was a failure and the inflation rate doubled to 60 percent. The flight of capital which had begun earlier also intensified.

While the foreign exchange situation was becoming very difficult, the PRI successfully elected Mr. de la Madrid as President in July before the full force of the crisis was felt.

In August, foreign exchange reserves were effectively depleted from their end 1981 level of over $5 billion. On August 5, the Finance Minister, Jesus Silva Herzog, announced a further devaluation and the unprecedented step of imposing exchange controls. A dual exchange rate system was imposed with a rate of about 50 pesos per dollar for exports, essential imports and debt service and a rate of 70 pesos per dollar for non-essential imports and the conversion of dollar deposit in Mexican banks, repayable only in pesos. On September 1, 1982 the lame duck President, Lopez Portillo, announced the nationalization of the banks in an attempt to lay the blame for the crisis on private bankers for facilitating and promoting capital flight.

Mexico began negotiations with the Fund and during the negotiations obtained bridging loans from the U.S. in the form of a prepayment for oil ($1.0 billion) and from the Bank for International Settlement ($1.05 billion). The

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Letter of Intent signed with the Fund on November 10, 1982, was jointly agreed to by the incoming de la Madrid administration which was to take office December 1. The agreement provided for a $3.9 billion loan over a three year adjustment period. The adjustment program called for a cut in the public sector deficit from 18% of GDP in 1982 to 8.5% in 1983, to 5.5% in 1984 and to 3.5% in 1985. In addition, extensive measures were required in the areas of subsidies, pricing, bank credit, and the exchange and trade system.

The stabilization program adopted by President de la Madrid's government enabled Mexico to negotiate a rescheduling of almost $23 billion of debts due in the period up to the end of 1984. In addition new commercial banks loans of $5 billion were secured during 1983. These measures together with the drawings from the Fund, restored international reserves and payments to some degree of normalcy.

The main target of the program in 1983 was to cut the public sector deficit from 18% of GDP to 8.5% and this was achieved. Supporting the increase in taxes and the cuts in expenditures was a set of monetary, exchange and trade measures to correct the imbalances. The main targets and the progress achieved in 1983 are shown in Table 6. All targets were met or exceeded.

The peso was kept undervalued throughout 1983. Scheduled rates of devaluation were instituted with respect to both the controlled and free rates at 13 centavos per day

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Table 6: Main Quarterly Targets of the 1983 Economic Adjustment Program
(end-of-period data)

	Q1	Q2	Q3	Q4
Central bank claims on the nonfinancial public sector (billions of pesos)				
Target ceiling	2.4	2.6	2.7	3.0
Actual	2.3	2.4	2.4	3.0
Net domestic assets of the central bank (billions of pesos)				
Target ceiling	0.6	0.6	0.6	0.7
Actual	0.4	0.3	0.0	0.5
Public-sector external debt ($ billions)				
Target ceiling	68.0	69.3	70.6	71.8
Actual	67.8	68.6	67.6	71.5
Net international reserves of the central bank ($ billions)				
Target	-0.5	0.0	0.5	1.5
Actual	0.8	1.4	3.1	5.0

Source: World Financial Markets, May 1984

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and by the end of 1983 the controlled rate had been depreciated to 144 pesos from 47 pesos to the dollar following the February 1982 devaluation. Taking inflation differentials with the U.S. since 1978, the purchasing power parity rate of the peso at the end of 1983 would have been 120. The actual end 1983 rate of 144 served to promote exports and inhibit imports and, together with restrictions on import licensing, the result was that the trade balance recorded a $14.5 million surplus, a remarkable turnaround from the deficit of $4.1 billion in 1981.

During 1984, progress slowed as the government gradually began to reflate the economy. The stringency of policies instituted in 1983 and the continued implementation of these improved policies during 1984 allowed Mexico to again meet the Fund's technical targets. However the implementation of the Fund's required policy initiatives in 1984 did not fully meet all of the objectives. For example, the inflation objective of 40% was exceeded as the 1984 rate amounted to 65%. The controlled devaluation at the rate of 13 centavos per day meant that the peso could maintain competitiveness only with inflation rates up to 32%. Thus the peso was once again in danger of becoming overvalued. Relaxed implementation was also evident in other fiscal, monetary and trade policies.

In connection with the 1984 Fund program, the first multiyear rescheduling of debt was negotiated by Mexico. The agreement covered $49.5 billion of repayments falling due in

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the 1985-90 period. Under this agreement Mexico achieved improved terms and reduced uncertainty concerning future obligations.

During 1985 it became increasingly evident that the Fund's targets could no longer be met. Through an unfortunate bit of timing the Fund announced just before the Mexico earthquake that Mexico's drawing rights had been suspended.

The peso became increasingly overvalued during 1985 given the accelerated level of government expenditures and the failure to cut the inflation rate. It would appear that there was a relationship between the acceleration in expenditures and the mid-term elections which PRI felt must be won with some degree of popular support. Traditional pork barrel politics took over.

Mexico also faced declining oil prices during 1985. A one dollar per barrel reduction in the price of oil costs Mexico approximately $550 million a year at current production levels of 1.5 million barrels per day. For example the price of Isthmus light (40% of Mexico's output) was reduced by $1.25 to $27.75 per barrel early in the year and in June June the Maya crude (60% of Mexico's output) was cut by $1.50 to $24 per barrel. These price cuts cost up to $800 million per year. In addition, further pressures for price cuts were building. Mexico, because of its policy of cooperation with OPEC pricing, lost major sales in June and July.
On July 10 Mexico finally became competitive again with a

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further cut of $1.10 per barrel for Isthmus and $0.77 per barrel for Mayan. Taking lost sales into account, export receipts from petroleum in 1985 were some $2 billion below expectations.

Reflecting the deterioration in fiscal and monetary policies as well as the weakening trade results, the government first increased the daily rate of devaluation to 21 centavos per day. However, that increased rate of devaluation proved inadequate and the peso in the free market began to plunge in early June. Chaos prevailed in the exchange markets as the free rate was deregulated on July 1 and the banks were allowed to enter the market. However, the market did not begin to stabilize until August 15 as the controlled rate was devalued 20% in peso terms and its subsequent daily adjustments were administered in a flexible manner taking inflation differentials and other factors into account. The markets remained nervous. As of October 11, 1985, the market rate was 399 pesos to the dollar while the controlled rate was 310 as compared to 193 pesos to the dollar at the end of 1984.

The government also began to liberalize the import system to allow Mexican industry access to imports. Discussions were also opened within Mexico as to the advisability of joining the General Agreement on Tariffs and Trade (GATT) which would necessitate foregoing many of the restrictive trade practices Mexico currently utilizes.

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Prospects for Mexico

Mexico had indicated that it would require an additional $2-3 billion in new commercial bank loans during 1986. Due to the earthquake and related problems, this amount has been increased to $4 billion. Commitments had already been received for the additional $600-800 million that Mexico needs this year. The Fund has granted a $300 million emergency loan while the World Bank has agreed to accelerate $300 million in loans already committed. International commercial banks have also agreed to let Mexico postpone for six months its principal repayments of $950 million that were due October 1, 1985. These helpful steps have given Mexico some breathing room, particularly in view of the pressure that has been on their international reserves in recent months.

The proposal by Secretary Baker, speaking for the Reagan Administration, at the Fund Bank Annual Meetings in Seoul dealing with the problems of debt-ridden countries such as Mexico comes at an ideal time. The concept of restructuring these economies to achieve greater efficiency and growth is exactly the right approach. Secretary Baker indicated that for debtor countries to participate in the program they would be required to take steps to attract more foreign investment, to liberalize trade and payments, and to transfer their inefficient state enterprises to the private sector. Most debt-ridden countries require this kind of restructuring and Mexico is a prime example. The Mexican economy is

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strangled by "rules and regulations" and the bureaucracy that administers them. For example, Mexico's recovery is crucially dependent on expanding non-petroleum exports. Yet as shown in Table 7, non-petroleum exports have stagnated and expectations are that non-petroleum exports will only amount to $7.5 billion in 1985. Greater reliance must be placed on prices and free markets to allocate resources. Mexico has already taken some beginning steps in these directions.

The problem with the Administration's program lies in the area of the incentives being proposed to gain the cooperation of the debtor countries in implementing such a restructuring effort. From press reports, the funds for the Administration's program would amount to $20-25 billion over 3 years from the international commercial banks plus an amount of about $5 billion to be raised from internal sources of the Fund and the World Bank. However, it is by no means apparent that agreement on these issues has been achieved.

Table 7: Composition of Exports
(in billions of U.S. dollars)

	Exports (f.o.b)		
	Petroleum (1)	Non-Petroleum	Total
1979	3.9	5.1	9.0
1980	9.8	5.8	15.6
1981	13.8	5.8	19.6
1982	17.0	4.8	21.8
1983	15.2	6.6	21.8
1984	16.4	7.9	24.3

Source: International Financial Statistics

(1) Crude and petroleum products

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In the case of Mexico, interest payments on their $96 billion debt will amount to about $10 billion in 1986. Assuming no repayments of principal, that amount of debt service represents about 50% of Mexico's earning from merchandise exports. In order to achieve the required trade surplus it will be necessary to restrain imports for the domestic economy. The severe austerity that would be required implies little or no hope for real growth over the next several years. This is an intolerable burden that cannot be sustained by Mexico or any other debtor country. Mexico and the other debtor countries need relief from their debt service burdens if they are going to be able to grow their way out of their current problems.

Under the Administration's program the new loans would be utilized in substance to pay part of the interest on current debt; the problem is that these new obligations would in turn add to the interest burden in later years. It will be a self defeating cycle. If debtor countries cannot afford their interest payments now, new loans will at best only postpone the problem and at worst will ensure these countries' eventual insolvency.

In order to extend the loans under the Administration's program, the international banks will no doubt require guarantees. Those guarantees are in turn backed by member countries including the United States. This is a back door route for the Administration to delay facing the real cost of a solution. The international banks by requiring guarantees

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are clearly indicating that the debtor countries are not credit-worthy under current conditions. If so, then why should the American public in effect guarantee those loans to ensure the debtor countries can service their existing bank debt? Thus both the form and the substance of the incentive side of the Administration package are wrong.

President Garcia of Peru hit a responsive note when he indicated he wished to limit debt service payment to 10% of export earnings. Before the loose lending period of the 1970s, it was considered dangerous for a country to allow its debt service payment to get much above 10%. Countries have handled debt service burdens up to 25 percent but certainly not anything in the neighborhood of Mexico's 50%. It must be remembered that Mexico's debt servicing is limited to interest payments and does not include principal repayments.

Within a general overall ceiling on debt service of perhaps 25 percent, help needs to be given to debtor countries to meet the interest cost of their external debt. The major industrial countries should fund an interest subsidy account from which up to one-half of the interest would be paid. This interest subsidy account would be administered by the Fund. To gain the interest subsidy, a debtor country would need to cosply with the Fund administered program and undertake the market oriented policy reforms. It should be emphasized that this interest rate assistance is an outright subsidy and is not subject to repayment. Further it is not intended to replace other

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intended to replace other bilateral or multilateral assistance.

The cost of such a subsidy program is well within reason. With developing countries' debt approaching $1,000 billion and interest rates presently in the vicinity of 10%, the total interest payments of all debtor countries is in the neighborhood of $100 billion per year. The subsidy program would be half that amount or $50 billion, if all developing countries participated.

This subsidy account could be funded in several different ways. For example, each industrial country's contribution could be tied to the amount of their loans. Moreover, each industrial country's contribution could be reduced by requiring commercial banks that have loans to to debtor countries to contribute some share of the annual subsidy bill. There is an incentive for the banks to participate, given the danger of default in the absence of any assistance. The importance of Mexican debt for U.S. banks is shown in Table 8. U.S. banks loans to Mexico total $35 billion and for the eight largest banks, such loans constitute about 50% of their equity. None of these banks could afford a Mexican default.

A second approach for funding the interest subsidy account might be to ask the top twenty industrial countries to contribute up to $2.5 billion each. This would be a small price to pay to prevent widespread defaults and the consequences for the international economy.

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Table 8: Exposure of Major Banks in Mexico, December 31, 1984 (in billions of U.S. dollars and percent)

Major U.S. Banks	Loans Outstanding	Percent of Shareholder Equity
Citicorp	3.00	47
Bank America Corp	2.78	54
Manufacturers Hanover Corp.	1.98	60
Chase Manhattan Corp.	1.75	44
Chemical New York Corp.	1.43	56
Bankers Trust	1.30	56
J. P. Morgan & Co.	1.20	37
First Chicago Corp.	0.93	48
Total of Listed Banks	14.37	N.A.
Total U.S. Bank Lending to Mexico	35.10	N.A.
Total U.S. and Foreign Bank Lending to Mexico	77.48	N.A.

Source: Donaldson Lufkon & Jenrette for the individual banks, The Bank for International Settlement and the Treasury Bulletin

Under this interest subsidy program, debtor countries would be able to continue and, for some countries, to begin to make principal repayments within the overall 25% debt service ceiling. Restoration of debt servicing in its fullest sense, namely the inclusion of principal repayment, is essential to restore some degree of normalcy to the international financial system.

With a flexibly administered limit on the amount of foreign exchange dedicated to debt service, debtor countries would have the needed foreign exchange reserves to promote investment and growth and restore their creditworthiness. But it is not a give away program as the recipients will be required to undertake a major restructuring of their economy

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to put it on a sound footing. However, they would not be required to impose austerity to limit imports to such an extent that growth is impeded. Rather they would be permitted to grow their way out of the debt crisis. It is this kind of approach that is needed for Mexico.

The costs to the United States for the solution of Mexico's debt crisis would be relatively small when compared with the policital and economic disruptions that could occur in our neighbor if no solution is found. If the debt crisis was equitably solved with each of the involved parties paying their fair share of the cost, the Mexican economy could be restructured to provide the needed growth. The economy would become more open and market related so that Mexico-U.S. trade would prosper and become more mutually beneficial. Immigration pressures would also lessen as the Mexican economic environment improved relative to the United States and adequate jobs were made available in Mexico. The costs are not large relative to the potential dangers from continued economic austerity, stagnation, unemployment and frustration. We can no longer afford to ignore these problems. We must proceed with positive proposals.

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Mr. MACKAY. Thank you, Mr. Dickie.

Mr. Lagomarsino.

Mr. LAGOMARSINO. Thank you, Mr. Chairman.

Dr. Dickie, I think your prescription for Mexico, your suggested prescription, makes sense. We could probably do it, but can we do it with all the other countries that are in a similar bind at that point: Brazil, Argentina? Have you looked into that? Would this be an appropriate remedy for their problems also?

Mr. DICKIE. I think it is necessary that we use that same general approach for all the heavily indebted countries, but it would be only accessible for those countries if they undertook the prescription of policy changes and they would only get that relief as long as they remained in compliance with that kind of a program. So I think the costs would not be that excessive. I think also, depending on the country and the relationship with the banks in that country, that the banks might be able to undertake some of that burden.

PROSPECTS FOR MEXICO OPENING UP TO PRIVATE FOREIGN INVESTMENTS

Mr. LAGOMARSINO. I would like to ask this of both of you, the same question I asked Secretary Michel. What in your opinion are the prospects for Mexico to further open its economy to private foreign investments?

Mr. DICKIE. I will go first.

The MIGA proposal, the Multilateral Investment Guarantee Assocation, that was initiated recently at the annual meetings of the World Bank and the International Monetary Fund in Seoul has some possibilities in terms of permitting an increased flow of investment to countries such as Mexico. The developing countries currently are not too happy with the general provisions of that agreement, and I am not sure whether, for example, Mexico would go along with it.

I think the most important thing that we can do to get that kind of flow is get economic stability and growth going in Mexico. That will give American investors assurance that they can go down there and see a rising volume of sales and profitability. It will also, if we get that kind of economy, keep Mexican money in Mexico. We are losing not only talented people from Mexico—we have got a decimated middle class—but we are losing the moneyed class from Mexico. If we could keep Mexican money in Mexico, we will be a long way ahead. So I would think the most important thing is stabilize that economy and alleviate the debt burden on Mexico.

Mr. LAGOMARSINO. Dr. Castaneda.

Mr. CASTANEDA. I think there are possibilities of the foreign investment law being liberalized or opened up a bit. What I am worried about, particularly since the proposal put forth by Secretary Baker, is to the extent that new loans, and particularly from the World Bank in its new system of guarantees, would be conditioned on countries such as Mexico openly changing their investment policies, the politics of the country would make it such that this makes it even more difficult to open up instead of less difficult. It may sound paradoxical, but local and domestic politics exist everywhere,

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including Mexico; and if the Government is viewed as doing things such as liberalizing its foreign investment laws because of pressure from abroad and because of conditionality for its loans, it might be much more difficult for the Government to do that even if it wanted to do so than if there were no such conditionality.

Mr. LAGOMARSINO. I think that is an accurate assessment. It does not answer how you get there from here, but I believe it is accurate. As I was saying earlier, I had the distinct impression, for example, that with respect to opening up trade, more liberalization of it, that the Mexican Government, the officials of the Mexican Government, had a different viewpoint than the legislators did or at least their public attitude was somewhat different, I think probably for the same reason you are talking about.

CORRUPTION AND ELECTION FRAUD IN MEXICO

Let me ask both of you this question. How significant are the issues of corruption and electoral fraud in this whole picture at this point? I know that earlier there was after the death of our DEA agent quite a campaign to root out corruption in the police department and so on.

Mr. CASTANEDA. There is no question that corruption is a problem in Mexico. It has been one for a great number of years. It is certainly not the most important problem the country faces, nor the single-most important vice, or defect the political system has, as is sometimes said, nor is it an entirely secondary issue either as others have said.

I think the earthquake and the relief after the earthquake have pointed out a series of contradictions and subtleties in the Mexican corruption picture in general which perhaps were not always as clear as now. We have all sorts of examples with which buildings fell down and which did not. We have the paradoxical things. For example, the tallest building in Mexico City is the new Pemex or oil company tower which was finished in 1982 and which was, in a sense, a symbol of what was viewed to be the oil monoply's corruption. Well, it was entirely untouched and undamaged by the earthquake. So what happened? Was there corruption? It did not bring the building down, or there was not as much as made out to be, or maybe the land under the tower was particularly strong in spite of corruption. I do not know. I do not think even the architects know. I would like to point out it is a bit more contradictory than it seems.

In fact, we have now in Mexico after the earthquake and after a tremendous amount of attention devoted by the Government to control and audit of all the foreign aid which has been received in Mexico to make sure that none has been, let us say, lifted from the airport or elsewhere, we now have grievances by many people who are saying, well, because of the bureaucratic procedures put in place by the Government to control the foreign aid, we are not getting it quickly enough. We would appreciate a certain percentage of it to disappear but get it quicker.

It is hard to say, but I think all of this is making it a bit clearer perhaps to many Mexicans and to many people abroad and perhaps

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putting a little more shade of gray in the black and white of corruption that was there before.

Mr. DICKIE. Since you raised the issue of corruption, it also has relevance to the changes of foreign bank loans ending up in Swiss bank accounts. Congressman McCain also raised this issue. The international debt crisis this time around is distinct from previous debt problems. In the 1930's we also had default problems with Latin American countries. During those years, bankers who gave a loan to a certain country tied up the foreign exchange revenues of the port authority or the oil company as security for the loan. Pretty soon the economy was strangled. They did not have any foreign exchange available for the general imports of that economy. This time around, strangely enough, we end up with general obligations, so that when bankers lend to these countries, they were not particularly vigilant that the projects were good ones. They would do a nominal review and if it did not look fully viable, they would request a Government guarantee. So this time we have general obligations, and as a result bankers did not follow up on projects to be sure they were effective and implemented carefully and that the loan proceeds all ended up invested in the project.

Mr. MACKAY. Mr. DeWine.

Mr. DEWINE. I have no questions, Mr. Chairman.

Mr. MACKAY. Mr. McCain.

Mr. MCCAIN. Thank you, Mr. Chairman.

I would like to thank both witnesses.

Dr. Castaneda, in your opening statement, again in your elaboration, you mentioned that there is, I believe you said, a clamor for change in Mexico, but there is not really a viable option both on the right and on the left of the political spectrum in Mexico. It seems to me that history tells us if there is a power vacuum and there is sufficient dissatisfaction on the part of the people that somebody is going to fill that vacuum. And perhaps that is not visible now as to what the option is, but doesn't it make sense that sooner or later a movement or group is going to arise which will provide the option if the level of dissatisfaction of the Mexican people continues to rise?

Mr. CASTANEDA. Certainly, which is why I stressed the need now with the earthquake for a very deep democratization of Mexican society. I think this is something now which is being clamored for by the left, by the right, by the private sector, by the Government itself, by intellectuals in universities, in the business sector, everyone, that precisely in order to avoid what could then become perhaps one day, not soon but one day, a power vacuum and which could be filled by anyone, as you say. I think there is certainly a serious viable possibility for this to happen, for democracy in Mexico to really become a fact of life, a way of life, and then we avoid other problems which would then occur otherwise.

Mr. MCCAIN. Dr. Dickie, I am very interested in your proposals in trying to get out from under this debt problem, and I hope that we carefully examine them by all the players, including the IMF and the World Bank and this administration. Tell me, what is your problem or the problem with a very simple solution as proposed by President Garcia, the 10-percent solution or 25-percent solution, whatever? Is that one we want to use?

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Mr. DICKIE. Congressman, it is an interesting question because when I started working in the international financial area, the 10-percent number, was viewed at that time as being a realistic one. If debt service was over 10 percent, then we thought the country was getting into trouble. So it does strike a responsive note.

The problem is how do you allocate the available foreign exchange and how do you an select those provisions of the contractual relationship between the country and the debtors that you will need to violate? It is a very difficult thing to implement. In the Mexican case, Mexico is paying about 50 percent of their merchandise export earnings or 70 percent of their oil earnings to service the debt in terms of interest only. I would think that that is way too high, that it must be brought down to something like a 25-percent maximum. That means that we have got to give relief, a continuing relief like we did in the first 2 years of that standby program of at least $5 billion a year to Mexico, so as to get that debt-service ratio down to a reasonable level.

Mr. MCCAIN. Thank you.

Thank you very much, Mr. Chairman.

Mr. MACKAY. Gentleman, this has been very helpful to us. We very much appreciate your participation.

At the request of the chairman I am going to include in the record two articles: one from World Magazine entitled "Mending Fences: Mexico and the U.S." I note the other is from the New York Times, "Playing it Smart with Mexico" by Catheryne Thorup.

[The information follows:]

[From the New York Times, Sept. 30, 1985]

PLAY IT SMART WITH MEXICO [1]

(By Cathryn Thorup)

WASHINGTON—The devastating earthquakes that rocked Mexico earlier this month were a severe blow to that country's effort to put its house in order economically and financially. But the natural disaster also served as a sobering reminder of the depth and breadth of United States ties to its troubled neighbor. Both factors argue for a new United States approach to Mexico.

The first of the quakes occured on Sept. 19, just as the Senate passed a new immigration bill that will further tax the Mexican Government's dwindling economic resources. The next day, the press reported that the International Monetary Fund might cut off lending to Mexico. Against this background, the natural disaster could easily be the coup de grace that sends the Mexican economy into a tailspin.

Its impact will be felt in falling tourist revenues and higher unemployment. The damage to the country's infrastructure and the need to divert scarce resources to reconstruction will also make for a fall in productivity. Added to declining oil prices, a debt burden of overwhelming proportions, the specter of renewed United States protectionism and the physical and mental exhaustion of a people whose standard of living has fallen more than 30 percent since 1982, this unexpected challenge is indeed staggering.

The Mexican Government will be hard pressed to deal with the new crisis. Even before the disaster, it was having difficulty meeting accumulated pressure from a populace weary of austerity, a hostile international economic environment and a demanding neighbor to the north. The current Government looks more favorably on the United States and the private sector than any Mexican administration in the last 15 years, and since 1982 it has gone to great lengths to reduce friction with Washington. Yet relations between the two countries have deteriorated significantly.

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Why? The blame lies in large part with the United States. The Reagan Administration has seemed dissatisfied with Mexico's traditional role as a reliable ally of last resort and has pressed instead for a more pliable and acquiescent partner. Neither public nor private sector in the United States has fully recognized Mexico's great effort to honor its debt and open its economy: On the contrary, many bankers and officials have continued to raise the hoops through which they require the Mexicans to jump.

Beyond this, few people in the United States seem to understand Mexico very well, despite our long and close relationship. Officials are baffled and frustrated by the complexities of a political system that has been ruled for more than 50 years by one party. They find it difficult to deal with the Mexican bureaucracy and make little effort to look beyond superficial press reports about Mexico's problems. As a result, the United States has tended increasingly to lose sight of its broader objectives—political stability and economic development—in Mexico.

The debt question is a case in point. If United States creditors, both public and private, continue to press Mexico as they have been doing, the Mexicans may well decide that the political costs of trying to play by the rules outweigh the costs of abandoning the international financial system. The result could be a temporary suspension of payments or a moratorium—with obvious catastrophic consequences.

To avoid this, Mexico's determination to honor its financial obligations must be met by an equal effort by the international financial community. Cosmetic solutions and repeated rescheduling will not solve the problem. What's needed is a far-ranging redistribution of the costs of adjustment among debtors and creditors alike.

The Mexican people are facing their natural disaster with unity and determination, and the effort to rebuild the capital city may do much to mend the national spirit. Drawing on international relief assistance and a deep well of national strength. Mexico can be expected to meet the immediate demands of the catastrophe. In the meantime, however, the United States should be rethinking its response to Mexico's long-term development plans. We have played hard over the last three years. It is time to play it smart.

[From World magazine]

Mending Fences: Mexico and the United States

(By Peter H. Smith)

Americans have long been ignorant of Mexico. For years the U.S. public has tended to view our southern neighbor as a sunlit collage of glitzy tourist havens and sleepy retirement communities. We have seen Mexico not as an emerging middle-range power but as a playground—a land of never-ending mananas and fun-loving mariachis. The stereotype has its darker side as well. Concern over debts and narcotics has aroused U.S. fears that Mexico has fallen prey to chaos and corruption. Mexico's people have thus been reduced to a hodgepodge of dozing peasants, fawning tourist guides, and scheming politicians. Our ignorance is pervasive, profound, and dangerous.

Offical Washington has generally adopted a posture of neglect that is not always benign, placing Mexico far down on the policy agenda—not only below the Soviet Union, Europe, and Japan, which is perhaps understandable, but also below Cuba, Nicaragua, and El Salvador, which makes no sense at all. Diplomatic pronouncements seen calculated to offend Mexican sensibilities rather than to encourage the pursuit of mutual interests. The recent outcry over drug trafficking provides a case in point. Mexicans recognize narcotics as a problem, but they see it, at least in part, as a response to consumer demand in the U.S. They resent the widespread assumption that they alone bear the blame.

For the Reagan administration, Mexico is the ultimate domino. Its principal importance is to serve as a rationale for U.S. policy in Central America. As President Reagan explained the case for aid to the Nicaraguan Contras: "If we provide too little help, our choice will be a Communist Central America with Communist subversion spreading southward and northward. We face the risk that 100 million people from Panama to our open southern border [sic] could come under the control of pro-Soviet regimes and threaten the United States with violence, economic chaos and a human tidal wave of refugees." A bit of arithmetic reveals that Mexico, with it population of 77 million, comprises the bulk of the threat. And there is the heart of the problem: the specter of a hostile Mexico, its leaders engaged in Communist conspiracy, its citizens pouring into the United States.

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This posture has provoked deep bitterness in Mexico. Officials, in private, express anger toward the United States and their dismay at the deterioration of the U.S.-Mexico relationship. Mexicans are apprehensive about the Reagan administration's belligerence in Central America. They are nettled by Washington's desire to dictate Mexico's own policy there: The Contadora effort is designed to achieve a lasting peace throughout the region—which is what the U.S. says it wants—and the very least Washington could do is to agree to disagree on means. They are perplexed by U.S. restrictions on Mexican imports at the very time Mexico stands in urgent need of foreign exchange in order to meet payments on the $96 billion national debt. They are annoyed by such provocative measures as the partial closing of the border in February of this year. They are troubled by one-side treatment in the U.S. media: At the height of the dispute over the murdered American drug investigator, one prime-time telecast showed American tourists deplaning in Guadalajara and gravely warned that "at least one" of these passengers would be victimized by crime while in Mexico. (Days later I nervously recalled the warning as my commuter flight approached New York.) They are upset by interventionist gestures, by northerners' preoccupation with the failures of the Mexican political system, and by Washington's apparent alliance with the right-wing opposition. As a leading Mexican novelist told me this spring, U.S.-Mexican relations are worse than at any other time in living memory.

What is the source of this confusion? What are the prospects for the future? What can the United States do to address its own and Mexico's concerns?

DEFINING THE RELATIONSHIP

The U.S.-Mexico connection is unique. Nowhere in the world does a First World country share a two thousand-mile border with a major Third World country. History and contiguity imbue the relationship with peculiar characteristics and inescapable realities.

One basic feature is asymmetry. The United States is bigger, stronger, and richer than Mexico and has been so even since the early nineteenth century, though not before. The U.S. has about three times the population of Mexico, fifteen times the GNP, and an overwhelming military superiority. Trade with the U.S. accounts for two-thirds of Mexico's international transactions, while trade with Mexico accounts for only .75 per cent of its northern neighbor's. "Poor Mexico," one well-known Mexican slogan goes, "so far from God and so close to the United States."

A second characteristic of the relationship is conflict. What's good for Mexico is not always good for the United States and vice versa—more precisely, what's good for certain interests in Mexico might not be good for certain interests in the U.S. With regard to commerce, for instance, the U.S. and Mexico have conventional buyer-seller disputes. The U.S. would like to purchase large amounts of Mexican oil at the lowest possible price; Mexico wants to reserve much of its petroleum for domestic development to avoid long-term dependence on a single purchaser and to fetch the highest price for exported oil. Such differences can be resolved through negotiation, even after the contemporary market glut, but they will not simply go away. They are part and parcel of the commercial connection.

Another point of conflict, migration, is a more complex issue. Illegal border crossings are commonplace, but since most Mexican migrants return to their homes, the net immigration appears to be somewhere between 300,000 and 500,000 per year, and the total stock of undocumented Mexicans is probably around 3 million—not, as alarmists have said, between 8 and 12 million. U.S. employers of undocumented workers obtain direct and tangible benefits from the presence of a docile, low-cost labor force. Objections come from their business competitors, who regard the migrants as the source of an unfair advantage, and from U.S. labor unions, which claim that Mexican workers take away jobs and push down wages. In Mexico too there is ambivalence about migration. In earlier times, when most of the illegals were unlettered peasants from the countryside, Mexican authorities tended to regard the out-migration as a means of acquiring foreign exchange and of taking pressure off the system; nowadays the migrants tend to be skilled workers from the cities, and officials are frequently heard to lament the drainage of the labor pool. This is a conflict marked as much by disagreement within the two countries as between them.

A third enduring feature of U.S.-Mexico relations is the limitations of diplomacy when it comes to resolving some key issues. This is partly due to the nature of such issues as migration, which responds to socioeconomic stimuli and stoutly resists official regulation. The truth is that with or without a Simpson-Mazzoli-type law, the powers of the states are limited in many areas.

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An additional constraint on diplomatic negotiation is inconsistency of policy. This is particularly true of the United States, where multitudinous government agencies, each with its own perspective and constituency, take an active part in the policy-making process. Inconsistency of policy is more likely to be a hallmark of U.S. policy toward Mexico than of its policy toward say, Cuba or even Nicaragua, where (to borrow a euphemism) the bilateral agendas are more clearly defined. In Mexico, in contrast, with a highly centralized government apparatus, it is presidential will that prevails. The wide dispersement of bureaucratic authority in the United States also suggests the difficulty it would have in negotiating and implementing a broad "package deal" with Mexico. The path of least resistance is the one that endeavors to bargain bit by bit.

Underlying the preceding realities are pervasive differences in culture, value systems, and appreciations of history. North Americans look to the future, while Mexicans, like most other civilized people, remain aware of the past. As the Mexican philosopher-poet Octavio Paz once said: "North Americans consider the world to be something that can be perfected, while we consider it to be something that can be redeemed."

Their concern with history instilled in Mexicans a deep-seated suspicion of the United States. They recall with bitterness the nineteenth-century disputes over Texas and the "war of the North American invasion" that led to the loss of half their territory. They remember U.S. intervention in the Mexican Revolution of 1910, including a naval occupation of the port of Veracruz and the dispatch of General John Pershing's "punitive expedition" against Pancho Villa. They are often reminded of strident U.S. opposition to the nationalization of oil in 1938.

Certain differences pertain to political culture. For a variety of reasons, the ideological center of the political spectrum in Mexico lies well to the left of the political center in the United States. The consequent discrepancies in political discourse not only impede understanding but also contribute to missed opportunities and a recurrent sense of betrayal. It is my judgment, for instance, that the Reagan administration (and the IMF) could find no more congenial and cooperative government in Mexico than that of President Miguel de la Madrid. Washington policymakers ought to recognize that de la Madrid has deliberately chosen to occupy the right-hand side of his nation's political spectrum, that he has incurred some costs in doing so, and that a shift to the left during the second half of his term should not be seen as quixotic—indeed, in Mexican terms, it might be nothing more than a movement toward the center.

Such differences between the two countries can produce misunderstandings and strain their relationship. But this alone does not explain the recent deterioration of U.S.-Mexican relations.

IDENTIFYING THE PROBLEM

It is not just a case of diplomatic blunders, though of these there have been plenty. Nor is simply a result of Reaganite ideology, though this has tended to heighten and exacerbate tensions. The ultimate cause of difficulties between Mexico and the United States lies in the failure—on both sides of the border, but especially in Washington—to analyze and appreciate the significance of some crucial long-run transitions.

In economic terms, the challenge for Mexico is not merely to meet its debt payments (though an annual debt service of $12 billion imposes a staggering burden) but to redefine its entire economic strategy. In order to recover from the 1982–83 debt crisis and to find a viable model for sustained growth, Mexico has embarked on a plan to expand non-traditional non-oil exports and pursue the path of export promotion. The hope is to stimulate productivity, create new jobs, improve the balance of payments, avoid overreliance on oil, and provide much-needed foreign exchange. The problem is that Mexico's main market is the United States—a country whose massive trade deficit (some $124 billion for 1984) has fostered a wave of protectionist sentiment. U.S. businessmen have complained about unfair "export subsidies" by the Mexican government, and U.S. labor leaders have decried the resultant threat to northern employment. Now at least the United States has agreed to extend the "injury test" to Mexico so that Americans will have to demonstrate the extent of their "injury" before a trade barrier can be erected. But this hardly begins to deal with the issue. The basic issue concerns the compatibility of national economic strategies, and it should be understood in this way.

In domestic politics Mexico faces a delicate moment. President de la Madrid and his advisors are attempting to repair the web of informal agreements among the state, the private sector, the foreign sector, peasants, workers, and the middle class

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that has provided the basis for Mexico's half-century of postrevolutionary stability. A kind of social contract, this series of working agreements was gravely weakened by the events of the early '80s, especially the bank nationalization of 1982. It can be resurrected or it can be redefined, but it cannot be left as it is. This will require some difficult decisions, some delicate compromises, and some breathing room from the United States.

In the international arena, Mexico is seeking a new role. It seems safe to assume that Mexico's position as a middle-range power and "newly industrializing country" (NIC) will be enhanced during and beyond the present decade. The international system is becoming more, rather than less, stratified, and such nations as Mexico, Brazil, India, Argentina, and Korea will have increasing opportunities to exert their power and gain in prestige on the regional level. Central America is a case in point: It is impossible to imagine a Contadora initiative during the 1950's, and probably even during the '60s.

There is every reason to believe that this change in power relationships will persist—and that it will be a continuing source of friction between Mexico and the U.S. Conflict seems inevitable as Washington searches for an appropriate response to the relative decline of its hegemony over the hemisphere. Finding an appropriate response is, in my judgment, one of the central intellectual and political challenges for U.S. foreign policy. Unless or until it is found, any assertions of a newly acquired influence by Mexico (and other NICs) will be resented by Washington and viewed as insolent encroachments on the traditional power of the United States.

Each of these trends can produce stress and strain, which are easily heightened by a distinctly new element in the U.S.-Mexico relationship: that of *volatility*. This has introduced a new measure of unpredictability into the situation, and its causes are several.

One cause is the sheer breadth of the bilateral agenda. There are so many connections between the two countries—trade, investment, energy, migration, drugs, concern with Central America, ad infinitum, that there is something to dispute over almost all the time. But it is impossible to know just *where* specific conflicts might emerge, and this makes it hard to manage the relationship.

Another cause of the present volatility is the shifting locus of decisionmaking in the United States. A widely dispersed bureaucracy has already been cited as a reason for the difficulty the U.S. has in devising and applying a consistent policy toward Mexico. When an issue undergoes "domestication," the decisionmaking process becomes even more widely dispersed. The fate of the Simpson-Mazzoli bill—a piece of legislation affecting Mexico that was homegrown in the United States—was determined by domestic, largely electoral, considerations, and it appears that, to an increasing degree, decisions of this sort will be made on the campaign trail.

Perhaps the most basic source of volatility is the fact that the U.S.-Mexican relationship is becoming more and more dependent on worldwide trends. A mutually beneficial relationship between the two countries requires a sustained recovery throughout the community of capitalist nations. A major blowup in the Middle East that would shut down oil exports would have serious repercussions for Mexico and the U.S.; some North Americans would probably counsel caution in U.S. dealings with its southern neighbor, while others would no doubt call for virtual annexation of Mexico's oil fields. Again, the ability of Argentina and Brazil to meet their debt obligations has implications for Mexico's dealings with *its* U.S. creditors. And the Reagan administration's tolerance of the Contadora initiative hinges in part on the way U.S.-Soviet talks are going. The point is so obvious that it is often overlooked: Relations between Mexico and the United States are subject to an increasing variety of external influences.

An illustration of how volatile U.S.-Mexican relations can be is a recent dispute connected with drug trafficking. It was only last year that the U.S. State Department singled out Mexico's anti-narcotics campaign for special praise (over three hundred Mexican drug enforcement agents have lost their lives in recent years), and drug trafficking was not an issue between the two countries until Enrique Camarena, a U.S. agent, disappeared in February, 1985, and was later found murdered. The current dispute stems not so much from the narcotics trade itself as from U.S. allegations that Mexican officials were slow to prosecute the Camarena case because of their own corruption and complicity in the matter. Arrests in March and April may have helped to counter the suspicion, but the damage had been done.

Beneath the U.S. allegations and Mexico's refutations lies a deeper, often unspoken, concern on both sides of the border: the prospects for continuing political stability in Mexico. Apparently, many Washington observers believe that Mexico's leaders have squandered their legitimacy and that the country might fall to forces of the Left. Many Mexicans believe that, whether intentionally or not, the U.S. has

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exerted a destabilizing influence that is pushing the country toward the Right. Both sides fear collapse, though they differ about its origin and direction. Such apprehension creates, intensifies, and reflects the volatility that has become an integral part of the bilateral relationship.

LOOKING AHEAD

What are the policy options available to Washington? The United States has a profound interest in Mexico. There is an economic concern—not only for repayment of the debt to U.S. banks and receptivity to U.S. investment, but also for the overall viability of the Mexican model. To illustrate the close economic relationship of Mexico and the United States: The reduction of imports by Mexico in the post-1982 period led to the loss of at least 200,000 jobs in the U.S. export sector. There is a social concern—one that derives from Mexican migration to the U.S. and its impact on the north's culture. And there is a political interest—Mexico's role as an effective broker between the United States and the rest of Latin America (and other Third World areas) and its maintenance of peace along the Rio Grande, which has made it possible for the U.S. to project its awesome power in other parts of the world.

The concerns are real, and the stakes are high and getting higher. How is the United States to deal with them?

One option is to confront and challenge Mexican authorities and try to bend them to our will. The United States could exert enormous pressure on Mexico in various ways: by threatening to impose trade restrictions, arrange a tourist boycott, limit credits and investment, tighten border security, and so on.

Such a get-tough policy may be feasible, but it is not sensible. It is hard to imagine what useful purpose could be served by confrontational tactics. Threats might persuade Mexico to adopt a timid stance on Central America, for instance, but they would not hold back the tide in Mexico toward an independent foreign policy. Indeed, such tactics can be expected to prove counterproductive—probably in the short run and certainly in the long run—and would entail unnecessarily high risks for the United States. Yet the most remarkable feature of this approach is the fact that so many people in Washington seem to favor it.

A second alternative is to maintain the status quo—an ad hoc collection of incremental and disorganized decisions punctuated by an occasional meeting of chief executives. At the moment the United States does not have a policy toward Mexico, and it has not had one for many years. Decisions are the bureaucracy's to make. So far, outright catastrophe has been avoided—relations have been quite peaceful since the 1930's—only because favorable conditions have permitted such an approach. But these are uncertain times and there are no clear trends; it seems foolish to base our posture toward Mexico on the assumption that propitious conditions will endure forever.

A third approach is to adopt an explicitly "special relationship"—forging a clear-cut policy that would serve U.S. interests by encouraging the peaceful evolution of the Mexican political system. Here, Mexico would occupy a relatively high place on Washington's foreign policy agenda, and it would receive sustained, high-level attention. Washington would make a concerted effort to coordinate its internal decisions, at the very least avoiding contradictions and inconsistencies. The integration of trade and financial policies by itself would make a major difference. The U.S. would attempt to reach bilateral accords of various kinds, perhaps in the form of limited "package deals" that would establish mutually acceptable rules of the game for trade, investment, even migration. In some or all of these areas the United States would offer frankly preferential treatment for Mexico.

Perhaps most important, the United States would accept Mexico's complete sovereignty over its own territory and foreign policy, acknowledge that country's particular achievements, and reach an agreement to disagree. This is not merely pious exhortation. The U.S. has much to gain from the successes of a flourishing and independent Mexico and much to lose from its disasters. We should consider such a policy because it is right and serves our own national interest.

Mr. MACKAY. Thank you very much for participating.

[Whereupon, at 4:10 p.m., the subcommittee was adjourned.]

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